Republic of Zambia

FINANCIAL SECTOR DEVELOPMENT PLAN FOR ZAMBIA

2004 – 2009

Ministry of Finance and National Planning

May 2004

ACRONYMS AND ABBREVIATIONS

ABDCZ	Association of Bureaux de Change in Zambia
AMC	Asset Management Company
AMIZ	Association of Microfinance Institutions in Zambia
ATM	Automated Teller Machine
BAZ	Bankers Association of Zambia
BFSA	Banking and Financial Services Act
BoZ	Bank of Zambia
BSD	Bank Supervision Department
CPI	Consumer Price Index
CSO	Central Statistical Office
DBZ	Development Bank of Zambia
DDACC	Direct Debits and Credits Clearing
DMU	Disaster Management Unit
EAZ	Economics Association of Zambia
EFTPOS	Electronic Funds Transfer Point of Sale
ESMP	Extended Staff Monitored Programme
EXIM Bank of Zambia	Export and Import Bank of Zambia
FATF	Financial Action Task Force
FSDP	Financial Sector Development Plan
GAAPs	Generally Accepted Accounting Principles
GDP	Gross Domestic Product
IMF	International Monetary Fund
IOD	Institute of Directors
LASF	Local Authority Superannuation Fund
LAZ	Law Association of Zambia
LuSE	Lusaka Stock Exchange
MAJAZ	Magistrates and Judges Association of Zambia
MFI	Micro Finance Institution
MoFNP	Ministry of Finance and National Planning
MoJ	Ministry of Justice
NAPSA	National Pension Scheme Authority
NBFI	Non-bank Financial Institution
NGO	Non-Governmental Organisation
NPA	Non-performing assets
NSCB	National Savings and Credit Bank
OMO	Open Market Operations
PAYE	Pay As You Earn
PIA	Pensions and Insurance Authority
PICZ	Professional Insurance Corporation of Zambia
PRGF	Poverty Reduction and Growth Facility
Repo	Repurchase agreement
RTGS	Real Time Gross Settlement
SADC	Southern African Development Community
SAP	Structural Adjustment Programme
SEC	Securities Exchange Commission
SIDO	Small-scale Industrial Development Organisation
VAT	Value Added Tax
ZACCI	Zambia Association of Chambers of Commerce and Industry
ZACI	Zambia Institute of Chartered Accountants
ZAM	Zambia Association of Manufacturers
ZECH	Zambia Electronic Clearing House
ZIOB	Zambia Institute of Bankers
ZIPSS	Zambia Integrated Payment and Settlement System
ZNBS	Zambia National Building Society
ZNCB	Zambia National Commercial Bank
ZNFU	Zambia National Farmers Union
ZRA	Zambia Revenue Authority
ZSIC	Zambia State Insurance Corporation

TABLE OF CONTENTS

EXECUTIVE SUMMARY

1.1 BACKGROUND TO THE FSDP

1. At independence in 1964, Zambia was one of the most prosperous countries in Africa. Its population, currently about 10 million, has, over the years witnessed a deterioration in its standard of living arising from the decline in the country's economic performance. This is attributed to oil price shocks of the 1970s and the decline in revenues from copper. Despite economic reforms in the 1980s and 1990s, the country continues to face the challenge of growing and diversifying its economy, while simultaneously addressing widespread and worsening poverty levels.

2. One of the widely recognised principal obstacles to economic growth has been the state of the financial sector, which currently plays a limited role in the economy. The financial sector is characterised by low financial intermediation (with limited access to financial services for the rural population and the low-to-middle income earners), high costs of funds and undeveloped money and capital market.

3. The vision for the Financial Sector is therefore to have a stable, sound and market-based financial system that support the efficient mobilisation and allocation of resources necessary to achieve economic diversification, sustainable growth and poverty reduction.

4. In order to realise this vision, a number of weaknesses in the financial sector need to be addressed including: (i) low financial intermediation; (ii) poor credit culture in the market; (iii) the multiple and potentially conflicting roles of the Government in the financial sector; (iii) the weak regulatory framework for non-bank financial institutions, insurance and pension funds; (iv) the undeveloped capital market; (v) lack of long-term development and housing finance; and (vi) the limited number of monetary policy instruments.

1.2 MACROECONOMIC ENVIRONMENT

5. Since the negative copper price shock of 1974, the Zambian Government has attempted to stabilize the macroeconomic environment through various programmes supported by the IMF and the World Bank. Currently, the Zambian Government is on an extended staff monitored programme (ESMP) with the IMF after which it hopes to get a new Poverty Reduction and Growth Facility (PRGF) arrangement in June 2004.

6. Consistent with Government's medium term macroeconomic objectives for the period 2004 to 2006, the following macroeconomic conditions were identified as being

desirable in supporting the growth of the Zambian financial sector: (i) raising economic growth to at least 5% by 2006; (ii) reducing inflation to a single digit; (iii) reaching the Highly Indebted Poor Countries Initiative (HIPC) completion point; (iv) building credibility by observing fiscal and other publicly announced macroeconomic targets; and (v) improving coordination between Government and the BoZ.

7. The major constraint facing the Zambian financial sector is low intermediation induced in part by the high incidence of crowding out of the private sector by the Government. The primary cause of this is the high stock of Government debt, which contributed to high interest rates on Government securities. This has continued to impede the contribution of the financial sector to economic development.

8. Since November 2003, interest rates on Government securities have been falling. This trend is attributed to:

i. The reduction in the statutory reserve ratio from 17.5% to 14% in October 2003;
ii. The reduction in Government borrowing; and
iii. The stability of the Kwacha leading to excess demand for Government securities.

9. Despite the decline in Government securities interest rates, commercial bank lending rates have remained high. To encourage commercial banks to further lower interest rates and increase lending to the privates sector, it is recommended that the Government and the Bank of Zambia (BoZ) continue implementing prudent fiscal and monetary policies.

1.3 KEY FINANCIAL SECTOR ISSUES

10. There are several common financial sector-wide challenges that have been identified. These include the dearth of skilled human resource, the inadequate legal infrastructure, different accounting and auditing standards, lack of financial safety nets, poor credit culture due to lack of a credit reference bureau, absence of anti-money laundering regulations and an inefficient payments system.

1.3.1 Human Resource Development

11. Sustainable development of the financial sector in Zambia requires a reliable and stable supply of human capital. Currently, the development of a sound financial sector has

been hindered by inadequate human resource capacity, occasioned by inadequate funding of educational institutions, weak enforcement of and compliance to educational standards, and the adverse effects of the HIV/AIDS pandemic.

12. The situation requires clearly and carefully established regulatory frameworks, policies, procedures, commitment and other support systems, which promote a conducive work culture. Key policy recommendations include: (i) the establishment of a standardised framework for staff recruitment, training and development; (ii) enforcement of minimum academic/professional requirements for financial sector employees; (iii) development of conducive work place HIV/AIDS policies; (iv) strengthening relevant institutions of learning to make them responsive to the competence needs of the financial sector; and (v) identifying new areas requiring training, such as, forensic accounting and investigation and good corporate governance.

1.3.2 Good Corporate Governance

13. The financial sector in Zambia requires institutions that are managed with integrity, probity and transparency in their effort to contribute positively to society. To this end, there is need for appropriate education, legislation and codes of best practice to facilitate the adoption of Good Corporate Governance principles.

1.3.3 Legal Infrastructure

14. The Zambian legal system is founded on the English common law and principles of equity applied by the English courts. Whereas a number of legislative changes have taken place under the English Acts, the Zambian laws have tended to lag behind and therefore not responsive to the changes in the socio-economic environment, largely, due to the predominance of state controls in the economic management of the country until the emergence of political pluralism and economic liberalisation in 1991.

15. In order to have a stable, sound and competitive financial system that facilitates efficient intermediation, it is imperative that the statutes that are applicable to the financial system are constantly reviewed to assess their relevancy and adequacy.

16. Key recommendations to develop the legal infrastructure include: (i) harmonising and strengthening all pieces of legislation relating to the financial sector, including strengthening corporate governance provisions in the Companies Act, Banking and

Financial Services Act, Insurance Act, National Pensions Scheme Act, Securities Act, Building Societies Act, Societies Act and the Cooperative Societies Act; (ii) enacting specific legislation on insolvency, liquidations and winding up of companies, corporate bodies registered under the Societies and Cooperative Societies Act, that are engaged in the financial sector or, in the alternative, strengthening provisions of existing laws; (iii) developing foreign currency regulations or enacting a law that would regulate how financial institutions, tourist enterprises, and others may account for foreign exchange transactions for statistical purposes; and (iv) developing the necessary regulations to give effect to the Prohibition and Prevention of Money Laundering Act number 14 of 2001.

1.3.4 Accounting and Auditing Standards

17. The Zambia Institute of Chartered Accountants adopted the International Financial Reporting Standards (IFRS), International Standards in Auditing (ISA) and the International Accounting Standards (IAS) in 2003. However, there is need to enact these standards into the Companies Act as the official reporting, accounting and auditing standards in Zambia in the preparation of financial statements. The Government should also expedite the enactment of the revised Accountants Act to improve compliancy to the accounting standards.

1.3.5 Regulatory Structures

18. Financial regulation and supervision in Zambia has over the last decade been structured around specialist institutions that were mainly established after the liberalisation of the economy in 1991. These comprise the BoZ, the Securities and Exchange Commission (SEC), and the Pensions and Insurance Authority (PIA). This situation has led to a number of overlaps and areas of conflict in the regulatory environment of financial services in Zambia, leaving room for regulatory arbitrage.

19. In order to minimise regulatory arbitrage in the Zambian financial sector, it is proposed that the capacity for self-regulation by industry associations, such as, those for bankers, insurers and pension fund managers be developed as a first line of prudential defence in light of the scarcity of regulatory resources.

1.3.6 Financial Safety Net

20. The stability of the financial sector is cardinal for the efficient functioning of the economy. The Zambian financial sector has continued to face threats of financial instability due to the failure of some financial institutions. The cost to Government has been high and public confidence in the financial institutions has remained uncertain.

21. Arising from Zambia's experiences with financial institutions failures, the BoZ, in consultation with other major stakeholders, is looking into the establishment of an appropriate deposit protection scheme for all deposit taking financial institutions.

1.3.7 Regional Integration

22. It is recognised that regional integration will provide an avenue to accelerate economic development and increase the competitiveness and growth of African economies by improving economies of scale. It is also recognised that regional integration will maximize the integration of regional economies into the global financial system. Recognised constraints include: (i) potential difficulties in managing the wide variations in the socio-economic development of African nations; (ii) different levels of development in infrastructure among members in the financial systems of member countries. This poses challenges in synchronising the architecture in the different financial systems; (iii) different laws obtaining in the different countries may prove to be a hindrance to effective integration in various areas of the financial sector; (iv) lack of resources among some member states to create and sustain regional structures and mechanisms; (v) competing demands brought about by belonging to more than one regional economic grouping; and (vi) weak capacity at national level to implement regional protocols.

1.3.8 Prevention of Money Laundering

23. The Prohibition and Prevention of Money Laundering Act 2001 (PPMLA) was promulgated in the year 2001. Some of the major issues that need to be considered in addressing money laundering concerns include: (i) expediting the issuance of appropriate anti- money laundering policy guidelines to the players in the market; (ii) monitoring the steps taken by regulated institutions in implementing these guidelines; (iii) educating and creating awareness amongst consumers as well as players in the market; and (iv) ensuring transparency in the conduct of business by the players, supervisory authorities and the Government.

24. Key recommendations include: (i) making the Anti-Money Laundering Investigations Unit more effective and operational as well as establishing a separate unit outside the Drug Enforcement Commission (DEC) to take care of the wider scope of money laundering activities as provided for in the PPMLA; (ii) the need for all supervisory authorities to set up separate internal units specifically to address all issues relating to the prevention of money laundering activities and issue appropriate guidelines for their various jurisdictions and ensure that the institutions they supervise comply with the regulations and the provisions of the PPMLA; (iii) executing memoranda of understanding amongst all the supervisory authorities for co-operation and exchange of information; (iv) the supervisory authorities should, in consultation with the regulated institutions, come up with a threshold for reporting and reporting format; and (v) introducing appropriate training programmes incorporating techniques in recognition and prevention of money laundering activities, common documentation and methods of imparting training so that all regulated institutions could provide standardised training to their staff members.

1.3.9 Payment Systems

25. Payment systems are envisaged to play a critical role in promoting greater access by the population to banking and financial services and a reduction in the use of cash as the main means of effecting payments in the economy. It is recognised that this will require extensive industry consultation, co-operation and project management to assure the successful implementation of the payment system recommendations made. These recommendations include the promotion of a variety of payment systems instruments that are both practical and cost effective to the user and provide a reasonable return to the provider. Other strategies are the promotion of public awareness on alternative non-cash means of effecting payments and implementation of risk reducing measures in payments business so as to contribute to building public confidence. In this regard, the enactment of supportive payment systems legislation needs to be expedited through the legislative process.

1.4 THE REGULATORY AUTHORITIES

26. Of the three institutions that regulate financial sector institutions, the BoZ regulates banks and financial institutions, the SEC regulates the securities market and the Stock Exchange, whereas the PIA oversees the operations of the pension schemes and the

insurance business. The major challenge facing the central bank and other regulatory authorities is the need to achieve adequate operational autonomy. In the case of the central bank, this autonomy would be enhanced through a robust institutional and legally binding mechanism of securing the tenure of office for the central bank Governor.

27. Under the current legal framework, the operational independence of the regulatory authorities is not fully assured. In this regard, the enactment of new legislation for the BoZ, PIA and the SEC, which is presently pending, must be expedited. It is also proposed that as a means of easing the acknowledged funding inadequacies of the PIA and the SEC, the imposition of a levy on pension contributions and insurance premiums, as well as the raising of current levels in supervisory fees, be considered.

1.5 BANKING SECTOR

28. The banking sector is faced with several constraints, including: (i) low financial intermediation; (ii) dependency of bank earnings on lending to blue chip corporate companies, foreign exchange trading and trading in Government securities; (iii) instability in the banking sector; (iv) complex liquidation process for banks in liquidation; (v) poor credit culture; (vi) weak legal infrastructure; and (vii) the high cost of banking services.

29. Key recommendations include: (i) enhancing the quality of supervision through the development of internal capacity; (ii) introducing a rule-based BoZ intervention in the industry to enable prompt corrective action and reduce the effects of regulatory forbearance; (iii) revision of liquidation procedures for failed banks and strengthening of bankruptcy laws; (iv) establishing a credit reference bureau to enhance credit culture; and (v) enhancing consumer protection mechanisms.

1.6 NON-BANK FINANCIAL INSTITUTIONS

30. The NBFIs comprise institutions regulated and supervised under the BFSA and contractual savings providers (pensions and insurance companies).

1.6.1 Specialist Lenders and Bureaux de Change

31. The non-bank financial institutions (NBFIs) play a complementary role to banks in the financial system. The NBFIs present a window for transforming the financial sector in Zambia through their role in long-term lending and provision of financial services to the

under-served rural consumers and small businesses often ignored by the traditional banking channels.

32. The focus is on key elements of a strategy for restructuring the development finance institutions, housing finance institutions and the rural banking institutions as well as developing a regulatory framework for the micro-finance institutions.

33. *Leasing companies*. The leasing companies are commercial ventures that are established under the Companies Act. Their principle activity is the provision of asset-based finance.

34. *Development Finance Institutions (DFIs)*. In Zambia, the DFIs were established and funded by the Government. Largely due to the deteriorating economic conditions and poor corporate governance, most of these institutions have been closed. The only exception is the Development Bank of Zambia (DBZ), which was recapitalised by Government in 1994/95 and later restructured in 2002 through the DBZ Amendment Act number 11 of 2001.

35. *Housing Finance Institutions (HFIs)*. HFIs traditionally provide banking services and mortgage lending. In Zambia HFIs have tended to take two major forms, namely, building societies and employer-sponsored housing loan schemes. However, the unsatisfactory overall performance and financial condition of the building society industry has limited the contribution of the housing finance institutions in the economy. The major constraints have been the unstable macroeconomic environment and the outdated Building Societies Act (BSA) of 1968, which has not been revised in line with the changing financial environment.

36. *Rural Banks and Microfinance Institutions*. Following the collapse of most of the subsidised and publicly funded rural finance institutions, such as, Lima Bank, ZCF Finance Services and the Cooperative Bank in the mid-1990s, there has been a gap in the provision of financial services to the low-income households in the rural and peri-urban areas.

37. In addition, many commercial banks, which had branches in peri-urban and rural areas, closed down a number of these branches. Commercial banks still maintaining rural branches do not cater for the financial needs of most of the people in rural areas owing to high bank charges and minimum amounts required for opening savings accounts. Further, the majority of Zambians are not able to meet the collateral requirements for the credit

facilities. This has created a gap in the provision of financial services to low-income households, especially in the rural areas.

38. *The micro finance institutions (MFIs)* have risen to fill the gap in the provision of financial services. MFIs offer financial services, such as, small loans and savings facilities in the peri-urban and rural areas. Although expansion is much slower in rural areas, growth is evident along the line of rail and the peri-urban areas of the country. The provision of financial services in the rural areas has been slow due to unsatisfactory supportive infrastructure and absence of an appropriate regulatory and supervisory framework.

39. The regulation and supervision of MFIs is still at an embryonic stage. The BoZ, through a comprehensive research and consultative process with stakeholders, is working on draft microfinance regulations that would create a safe, sound, stable and efficient environment in which microfinance institutions could operate.

40. *Bureaux de Change*: These are foreign exchange shops that buy and sell foreign exchange in small amounts and do not take deposits. From April 2003, bureaux de change have been operating under SI number 38 issued under the BFSA and are required to comply with the 25% shareholding limit applicable to other financial institutions.

41. Key recommendations for the specialist lenders and bureaux de change include: (i) repealing the DBZ Act, NSCB Act and BSA; (ii) restructuring or closing insolvent non-bank financial institutions; (iii) incorporating DFIs, HFIs rural banks and MFIs under the Companies Act; (iv) establishing a legislative framework to provide for effective regulation and supervision of DFIs, HFIs, rural banks and MFIs; (v) reviewing VAT on lease finance charges in order to stimulate growth of the leasing sector; and (vi) reviewing the 25% shareholding limit.

1.6.2 Contractual Savings Providers

42. *Insurance industry*. The major concerns in the insurance industry include: (i) low market penetration (premiums stood at about 1.4% of GDP in 2002); (ii) inadequacies in the Insurance Act with regard to prudential supervision and regulation; (iii) externalisation of insurance funds; and (iv) lack of capacity to handle mega risks.

43. Key recommendations to develop the insurance industry include: (i) upgrading the legal and regulatory framework to the level as prescribed by the International Association of Insurance Supervision (IAIS) standards; (ii) enhancing the quality and independence of

the insurance regulatory office; (iii) harmonising legislation affecting insurance business; (iv) development of a policy on insurance of national assets; and (v) realignment of health insurance regulations and establishment of an indigenous reinsurance company.

44. *Pension Schemes*. The major concerns in the pensions industry include: (i) lack of harmony in legislation relating to pensions; (ii) inadequacies in the Pension Scheme Regulations Act, 1996; (iii) deficits in the statutory pension funds as a result of non-remittance of pension contributions by the state; (iv) lack of a supervisory agent for NAPSA; (v) absence of local actuaries; (vi) inadequate tax incentives and a lack of investment guidelines; (vii) impact of HIV/AIDS on pension funds; and (viii) lack of knowledge concerning pensions by the public.

45. Key recommendations to develop the pension funds include: (i) amending the Pensions Scheme Regulation Act, 1996 and harmonising all legislation affecting pensions; (ii) enhancing tax incentives for pension funds; (iii) effecting of consumer education programmes; (iv) conducting a study on viability of personal pension plans; (v) reviewing the need for an independent supervisory authority for NAPSA; (vi) training of local actuaries; and (vii) establishment of investment guidelines.

1.7 FINANCIAL MARKETS

46. Prior to Zambia's economic reforms of the 1990's, the financial sector was heavily controlled. Under this regime of administrative controls the financial system remained under-developed and repressed.

47. Since 1992, following the financial reforms in Zambia, interest and exchange rate controls were removed, while the payments system has been improved and modernised. Although lending rates have become positive in real terms, virtually all real savings rates are still negative, thereby discouraging savings in the banking system and giving rise to large interest rate spreads in the banking sector.

48. Commercial banks have maintained high lending interest rates partly due to the perceived risk associated with default and the high volume of non-performing loans on their books. In addition, continued high borrowing by Government from the banking system through the issuance of Government securities remains an impediment towards further interest rate reduction.

49. In the area of monetary policy management, although the rate of inflation has reduced from three digits to an average of 25%, it still remains high. The challenge for monetary authorities is to reduce current double-digit inflation rates to single digit and to achieve a relatively stable and competitive exchange rate in order to reduce uncertainties in the financial markets. Other general challenges in the development of the financial markets in Zambia include: (i) the limited number of effective financial instruments; (ii) underdeveloped secondary markets; and (iii) low overall market liquidity.

1.7.1 Money Markets

50. The Zambian money market comprises the interbank, discount and Treasury bills markets. While a number of improvements have been registered in the primary market for Government securities, secondary market activity remains low. In addition, poor cash management on the part of Government causes large swings in the amount of funds in the money market that lead to volatility in the interbank interest rates. Commercial banks also hold huge balances in their settlement accounts. There is, therefore, a need for the Government to improve its cash management.

1.7.2 The Foreign Exchange Market

51. The foreign exchange market has, since independence, undergone various changes. From 1964 through to the early 1980's, the foreign exchange market was characterised by administrative controls, with the Kwacha firstly being pegged to the US dollar then later to the Special Drawing Rights. In the 1980's through to the 1990s, the exchange rate was determined by a quasi-market system and later by a Foreign Exchange Management Committee. The market was finally liberalised in the early 1990s.

52. In 2003, the BoZ decided to establish a broad-based inter-bank foreign exchange system as the main vehicle to drive the foreign exchange market in Zambia. This basically entailed the movement of the wholesale market from the BoZ to the commercial banks.

53. The rationale for introducing a broad-based interbank system was to address the shortcomings in the BoZ Dealing Window system, in particular, the multiple exchange rates that had emerged in the various segments of the foreign exchange market. Furthermore, despite commercial banks being allowed to trade freely in Zambia, a functioning inter-bank market in the traditional sense of the term, with two-way pricing, had never emerged.

54. Currently, the major concern in the foreign exchange market is the process of dollarisation that had taken root in Zambia thereby hindering the capacity of the BoZ to conduct appropriate monetary policy.

55. Key recommendations aimed at developing the financial market include: (i) introduction of market-makers followed by a well-articulated code of conduct in the securities market; (ii) resolving problems in the secondary market; (iii) establishing criteria for determining corporate institutions which qualify to issue tradable financial instruments; (iv) establishing a rating agency; (v) improving liquidity management through enhanced coordination between MoFN and the BoZ on the flow of Government funding and tax revenue between the banking system and the central bank; (vi) increased use of repurchase agreements (repos) as the securities market develops; (vii) encourage corporations to use the debt market to fund long-term projects through issuance of long-term corporate bonds; (viii) to enhance participation in the provision of long-term finance, there is need for the MoFNP to quickly deal with the submissions made by various stakeholders to amend the current section 25 (3) of the Pension Scheme Regulation Act to empower the Minister of Finance to issue investment guidelines that will require institutional investors to channel a minimum amount of their mobilised savings to investment in capital market instruments issued by private and public sector enterprises; (ix) in reviewing all pieces of legislation that affect the operations of the financial sector, there is need to speed up the process of submitting the Central Securities Depository draft bills by the Ministry of Finance and National Planning to Parliament for enactment; (x) the Government, should introduce longer term Government bonds. (xi) the Lusaka Stock Exchange should carry out intensive awareness campaigns to improve the public's knowledge and confidence in capital markets transactions; (xii) Drafting of the Financial services Charter that will empower Zambians through ownership in the financial services organisations.

1.7.3 Capital Markets

56. The capital market in Zambia has remained small, both in absolute terms and relative to the size of the economy. The main challenge that Zambia faces in the capital market is to develop a broad and deep secondary market for bonds.

57. Other challenges in the capital market include: (i) *The macroeconomic environment:* Major impediments to the development of the capital market are the high inflation and interest rates that have characterised the macroeconomic environment. (ii) *The regulatory*

model for the capital market is financially unsustainable. The Securities and Exchange Commission is under-funded to the extent that it is not in a position to adequately fulfil its mandated regulatory function.

1.7.4 Venture Capital Funds

58. There is an institutional gap in the provision of long-term capital to small and medium sized businesses and an opportunity exists for venture capital funds to fill this supply gap. To develop the venture capital industry, it will be necessary to address the capital markets development issues outlined above, to ensure easy exit for venture capital investments once they mature.

59. Additional policy recommendations include: (i) reviewing the tax regime in line with those existing in countries where venture capital funds have flourished; (ii) allowing institutional investors, such as, insurance companies and pension funds to invest a certain percentage of their net assets in venture capital companies; (iii) undertaking a study of the most appropriate form of venture capital company and of programmes successfully used in other countries to 'seed' the industry; and (iv) putting such a 'seed' programme in place in Zambia.

1.8 FSDP IMPLEMENTATION

60. The Minister of Finance and National Planning shall appoint a Financial Sector Development Committee (FSDC) comprising key stakeholders to oversee the implementation of the FSDP for a 5-year term

61. The Committee will serve as a Steering Committee to give overall direction and advice on the implementation of the FSDP.

MAIN REPORT

1 BACKGROUND TO THE FINANCIAL SECTOR DEVELOPMENT PLAN (FSDP)

1.1 OVERVIEW

62. At the time of independence in 1964, Zambia was relatively wealthy, as judged by the standards of other countries on the African continent. This was mainly due to a large mining sector, which produced copper accounting for more than 80 percent of total export earnings.

63. The situation changed drastically in the early 1970s as a result of the oil price shocks and a substantial fall in the price of copper in 1974. The mono-commodity nature of Zambia's economy meant that the impact of lower copper prices severely affected overall economic performance.

64. The situation has not improved ever since and the country remains predominantly a copper dependent economy and faces a number of challenges including high levels of indebtedness relative to national output and exports, the need to diversify the economy and addressing wide spread poverty. One of the major impediments to addressing these challenges is the state of the financial sector, which is characterised by low intermediation.

1.2 WEAKNESSES IN THE FINANCIAL SECTOR

65. Concerned with the limited contribution of the financial sector to economic development, the Government devised and formulated policy mechanisms for addressing the identified obstacles within the framework of the Poverty Reduction Strategy Paper (PRSP) whose implementation started in 2002. In line with the PRSP framework, the World Bank and the International Monetary Fund undertook an assessment of the financial system through the Financial Sector Assessment Programme (FSAP) which identified the following weaknesses in the Zambian financial sector:

i. *Financial intermediation is low* and the existing highly segmented financial system plays a limited role in the economy. The ratio of private sector credit to GDP in 2001 was one of the lowest in Sub- Saharan Africa at 6% whilst that of public sector credit, at 14%, was one of the highest. *Access to financial services is very limited for low-income consumers* while there are a handful of micro finance institutions that are expected to fill in the gap in the provision of financial services.

ii. Public financial institutions that were established to provide various financial services to the majority of the people in the country are insolvent, and therefore ineffective, or have closed down. Examples include ZNBS (mortgages); LIMA Bank and Co-operative Bank (agriculture lending), EXIM Bank (export and import finance), DBZ (long term finance) and NSCB (banking services for the rural populace).

iii. *The financial system is dominated by commercial banks*, which are expected to cater for all the credit needs of the economy. As such, there is a financial intermediary gap in the formal financial sector.

iv. *Net interest margin and the ratio of fee income to average assets in banks are among the highest in Africa*. The operating costs of commercial banks are high by international standards, especially given moderate lending and depository services. This makes the provision of financial services unaffordable. In addition, commercial banks are increasingly relying on income from treasury bills and foreign exchange operations. This makes them vulnerable to adverse changes in the financial markets and could threaten their long-term solvency.

v. *Banks are highly exposed to an array of potential risks specific to structural weaknesses of the economy* such as the dependence on the copper sector, non-performance of public sector borrowings and adverse movements in interest and exchange rates.

vi. *There are no formal structures for a financial safety net in Zambia,* thereby leaving the public exposed to suffer losses every time there is a bank failure, although an explicit pay out of K500,000 is in place through Act No. 28 of 1995 and the establishment of a deposit insurance scheme is under consideration for implementation.

vii. *Despite compliance to most international standards, problems still exist in the supervisory process*, such as low minimum capital requirements, lack of independence from the Government, non-implementation of consolidated supervision, and lack of adequate procedures for the orderly liquidation of banks and other financial institutions.

viii. *Several weaknesses in the regulation and supervision of contractual savings exist*. Specifically the Insurance Act does not adequately provide for effective prudential regulations, the Securities and Exchange Commission and the Pensions and Insurance Authority are under-funded and lack requisite supervisory skills to effectively carry out their duties. Further, NAPSA is not supervised by an independent regulatory body.

ix. There exists weak responsiveness of the labour market to the skill and knowledge needs of the financial sector

x. There are *limited resources to train supervisory staff*. While market activities of some banks and non-bank financial institutions are becoming more complex in line with developments in the international financial systems, the supervisory skills gap continues to lag behind.

xi. *Poor credit culture*. The credit rating of customers who default in liquidated or existing banks is not affected by their previous record.

xii. *The government has multiple and potentially conflicting roles in the financial sector*. It is the regulator, supervisor, owner of several large financial institutions, the main borrower from the financial system, client and major depositor and user of financial services. These roles create problems of lack of transparency and potential conflict of interest.

xiii. *Administrative weaknesses in the payment system cause delays and inefficiencies in the process of remitting tax revenue to BoZ, thereby creating some float in the financial system.*

xiv. *While certain improvements have been registered in primary market activity for government securities, secondary market activity remains extremely low*. The commercial banks' holding of securities to maturity has stifled secondary market activity.

xv. *Fiscal and monetary policy implementation are not well coordinated, such that liquidity shocks that emanate from unanticipated Government spending are not sufficiently smoothened out, causing volatility in the inter-bank money market*. A complicating factor in BoZ's liquidity management is the uncertainty in the government's financing operations. The difficulty in reliably projecting Government's cash flow and absorbing liquidity through open market operations (OMO) and Treasury bills auctions hamper BoZ's control of liquidity. These unanticipated upsurges in liquidity are the primary cause of volatility in the inter-bank money market interest rates.

xvi. *Direct instruments of monetary policy implementation, such as statutory reserve ratios, are still prominent in Zambia's monetary framework*. The relatively high statutory reserve ratios tend to raise the cost of funds for banks. The final incidence of this cost is often passed over by the banks to the public by offering lower deposit and or higher lending rates.

xvii. *The financing of persistent fiscal deficits has created distortions in the financial markets*. Government borrowing through issuance of government securities to finance large fiscal deficit has significantly reduced the amount of loanable funds in the financial sector and contributed to the high cost of credit and the subsequent crowding-out of private investment. Furthermore, Government borrowing from the BoZ, to supplement deficit financing has often left BoZ with a daunting task of keeping the growth of money supply within the desired realm.

xviii. *Despite having a potentially unsustainable stock of domestic debt, there is no deliberate programme in place to manage this debt stock*. With a domestic debt to GDP ratio of 9.8% in 2002, Zambia has one of the highest debt ratios in Sub-Saharan Africa.

66. In light of the above, this FSDP has been prepared in order to address the weaknesses identified above and to provide for a systematic and coherent approach for the realisation of the vision for the financial system.

1.3 FINANCIAL SECTOR DEVELOPMENT PLAN

67. This FSDP represents a comprehensive strategy that has been formulated to address the current weaknesses in the Zambian financial system as well as guide efforts aimed at realising the vision of a financial system that is stable, sound and market-based and that would support efficient resource mobilisation necessary for economic diversification and sustainable growth. It will also serve as a coordinating framework for a number of parallel sub-sector strategies and efforts aimed at modernising and deepening the Zambian financial system such as the law review programme, the rural banking strategy and the Poverty Reduction Strategy Paper (PRSP).

1.3.1 FSDP National Committee

68. A National Committee to develop a FSDP was constituted on 9th October 2002 to identify and analyse the factors that have led to the current state of the financial system and make recommendations on the nature of institutional, legal and regulatory arrangements that will ensure attainment of the vision. The National Committee, whose members were selected based on their significance and overall impact to the financial sector comprises the following:

i. BoZ
ii. Pensions and Insurance Authority (PIA)
iii. Securities and Exchange Commission (SEC)
iv. National Pension Scheme Authority (NAPSA)
v. Development Bank of Zambia (DBZ)

vi. Bankers Association of Zambia (BAZ)
vii. Association of Micro finance Institutions in Zambia (AMIZ)
viii. Building societies
ix. Ministry of Finance and National Planning (MoFNP)
x. International Monetary Fund (IMF) and World Bank in an advisory capacity.

69. In addition to the FSDP National Committee members, a number of organisations were identified as key stakeholders in the drafting of the FSDP and are also expected to play a supportive role in the smooth implementation of the FSDP. These are:

i. Patents and Companies Registration Office (PACRO)
ii. Zambia Revenue Authority (ZRA)
iii. Zambia Association of Manufacturers (ZAM)
iv. Zambia National Farmers Union (ZNFU)
v. Zambia Association of Chambers of Commerce & Industry (ZACCI)
vi. Economics Association of Zambia (EAZ)
vii. Ministry of Commerce, Trade and Industry (MCTI)
viii. Ministry of Legal affairs (MoLA)

1.4 VISION AND OBJECTIVES

70. It is envisioned that the Zambian financial system will develop to become a stable, sound and market-based financial system that would support efficient rmobilisation and allocation of resources necessary for economic diversification, sustainable growth and poverty reduction. In this regard, key objectives that should be achieved in pursuance of the vision for the financial system include the following:

i. To restore sustained economic growth and macroeconomic stability;
ii. Have an effective and efficient legal and regulatory framework that promotes a vibrant, competitive and well functioning financial system in Zambia by harmonising the legal infrastructure relating to the financial sector;
iii. Deepen the financial market to enable banks, companies and households with the means for effective liquidity management, price discovery, cost reduction and enhance capital formation;

iv. Have a viable pro-poor and effective rural finance system for providing affordable financial services to enable the poor to enhance income and reduce poverty;

v. Have an insurance sector that adequately protects business and individuals from catastrophic events and a pension system that provides a secure retirement and to enable these institutions provide capital for long term investment in the real sector;

vi. Deepen and broaden the non-banking financial sector that will create a more balanced financial structure and promote competition.

vii. Contain deterioration in the financial condition of public financial institutions and implement a problem resolution strategy.

viii. Enhance legal, accounting and auditing systems that promote the rule of law in commercial and financial transactions and support good governance by promoting transparency, accountability and predictability.

ix. Establish a transparent government relationship with the financial system and address all sources of potential conflict of interest.

x. Strengthen the credit culture.

xi. Create a support structure for imparting training to the various players in the financial sector.

xii. Strengthen the BoZ and other financial sector regulators in such a manner that they would be able to play their roles more independently and effectively.

xiii. Raise the level of investments and strengthen the role of the private sector in the financial sector.

xiv. Ascertain whether the establishment of a single regulatory body is suitable for the financial sector in Zambian.

xv. Put in place ways and means of ensuring that proper mechanism is put in place to prevent and detect money-laundering activities through market discipline and transparency in the conduct of financial services business.

xvi. To manage regulations governing public borrowing to bring about greater openness and accountability in public debt management thereby facilitate more growth and poverty reduction.

1.4.1 The Role of Government and BoZ

71. As advisor to the Government, BoZ's role on the FSDP National Committee was to coordinate the drafting of the FSDP. Government's role will be to ensure implementation of the plan.

1.5 OTHER FINANCIAL SECTOR STRATEGIES

72. Apart from the FSDP, there are other already existing strategies in which financial sector issues are being addressed. These include the Poverty Reduction Strategy Paper (PRSP), the Domestic Debt Strategy Paper, the Capital Market Development Strategy and the Rural Finance Programme sponsored by the International Fund for Agricultural Development (IFAD) and other cooperating partners.

2 MACRO-ECONOMIC ENVIRONMENT

2.1 INTRODUCTION

73. Consistent with Government's medium term macroeconomic objectives for the period 2004 to 2006, the following macroeconomic conditions were identified as being desirable in supporting the growth of the Zambian financial sector: (i) raising economic growth to at least 5% by 2006; (ii) reducing inflation to a single digit; (iii) reaching the Highly Indebted Poor Countries Initiative (HIPC) completion point; (iv) building credibility by observing fiscal and other publicly announced macroeconomic targets; and (v) improving coordination between Government and the BoZ.

74. Macroeconomic policy, among other things, addresses real growth, balance of payments, inflation and the exchange rate. The Government seeks to influence these macroeconomic parameters through fiscal, monetary and external sector policies.

75. Macroeconomic policies impact on growth (both directly and indirectly) through (i) measures that promote growth, such as public investments in physical and social infrastructure and the associated incomes they generate and support (ii) measures that promote an enabling stable macroeconomic environment characterised by low inflation, a sustainable external sector balance and hence a stable and competitive exchange rate. Sustained growth in real output is necessary, although not sufficient, to reduce poverty.

2.2 ECONOMIC BACKGROUND

76. The Zambian economy was relatively strong due to the favourable copper prices at the time of independence. However, it deteriorated mainly as a result of the oil price shock, the falling copper prices in the 1970's and inadequate economic management response.

77. In the expectation that the fall in the copper price was a temporary phenomenon, the Government tried to maintain consumption levels by increasing subsidies. This led to the deterioration in the fiscal position. Initially, the Government financed budget deficits from external borrowing, but later it turned increasingly to domestic financing when external sources of financing became difficult to obtain. This contributed to growth in money supply consequently increasing inflationary pressures in the economy, leading the Government to maintaining the exchange rate at fixed levels and resorting to price

controls. The resulting price distortions contributed to misallocation of resources as they encouraged imports at the expense of exports.

78. In an attempt to correct the above internal and external imbalances the Government entered into several arrangements with the IMF and the World Bank on the appropriate courses of action. However, the Government found the political consequences of the necessary economic measures too difficult to bear and hence abandoned these measures. For instance, in 1987, reductions in maize meal (staple food) subsidies led to riots and the ultimate abandonment of the IMF and World Bank supported programme.

79. The Government returned to earlier policy measures, involving extensive controls of the economy. Although improved copper prices and a good agricultural season in 1988 helped to increase growth to over 6 percent, inflation continued to accelerate, shortages of goods became endemic, smuggling of goods to neighbouring countries increased and parallel markets for foreign exchange became increasingly prevalent.

80. Faced with a difficult situation, the Government again initiated discussions with the IMF and the World Bank, leading to an agreement on a policy framework paper in September 1989 and an agreement on an IMF monitored programme in March 1990. Economic reforms were supported by political reforms and the election of a new Government in November 1991. These economic reforms were expected to achieve the following:

i. A stable macroeconomic environment;
ii. Private sector led development through privatisation; and
iii. Sustainable external position.

81. The new Government, under the Rights Accumulation Program (RAP) covering the period 1992 -1995, implemented extensive market oriented reforms. Prices were liberalised, interest rates were decontrolled and the Kwacha was allowed to float. Since the conclusion of the RAP in 1995, Zambia has had two arrangements with the IMF. In December 1995, a three-year ESAF arrangement was approved by the Executive Board of the IMF. In March 1999, the Executive Board approved a three-year PRGF arrangement.

82. The PRGF arrangement expired in March 2003 due to fiscal slippages. Currently, Zambia is on an Extended Staff Monitored Programme (ESMP) after which Zambia hopes

to qualify for a new PRGF arrangement in June 2004 and to reach the HIPC Initiative completion point at the end of 2004.

83. Since the economic reforms of 1992, some degree of macroeconomic stability has been achieved as evidenced by the reduction in inflation from three digit to two digit levels, the increase in non-traditional exports from US$ 71 million in 1994 to over US$ 400 million 2003 and the significant improvement in the investment climate. In addition, GDP growth has averaged 4 percent in the past five years. However, Zambia remains a highly copper dependent economy and has one of the highest levels of indebtedness, relative to national output and exports.

2.3 CONSTRAINTS AND ISSUES

84. Despite a number of measures taken to improve the economy, several challenges continue including:

i. *Coordination of fiscal and monetary policy*: Persistent fiscal deficits present a serious challenge to the implementation of monetary policy. To finance these deficits the Government has relied on excessive external and internal borrowing. Borrowing from the central bank adds to reserve money, thereby increasing money supply and consequently inducing inflationary pressures. Excessive borrowing from the domestic market results in the crowding-out of the private sector. Further, inadequate coordination between the MoFNP and BoZ regarding the flow of government revenue and expenditure causes unanticipated shifts in money market liquidity and interest rates;

ii. *Underdeveloped and Segmented Financial Markets:* The initial interface between monetary policy and the rest of the economy takes place in the money market. As such, the efficiency, liquidity and responsiveness of this market are of paramount importance to the effectiveness of market-based monetary policy instruments. Because government securities are the main instrument of OMO, the level of secondary market activity has a direct bearing on the effectiveness of monetary policy. Underdeveloped and segmented financial markets reduce the effectiveness of monetary policy;

iii. *Dollarisation:* Recent trends in the economy toward dollarisation by way of quoting the prices of goods and services in United States (US) dollars, and in some cases demanding the settlement of domestic transactions in US dollars, clearly compromises the effectiveness of monetary policy. This is because the conduct of monetary policy is primarily directed at controlling the level of the domestic currency component of money supply and therefore monetary policy is weakened. In addition, dollarisation has contributed to unwarranted excess demand for foreign exchange, thereby exerting pressure on the domestic currency to depreciate. This frustrates the BoZ's efforts to stabilise the domestic currency's exchange rate and bringing inflation under control;

iv. *Savings and investments*. National savings that are important to finance national investments and thereby boost real economic growth have fallen over the years to levels that are inadequate to fund desirable investment;

v. *Financial developments*. Monetary policy has two broad objectives, reducing inflation and sustaining financial system stability. Although inflation over the past decade has fallen, it has remained at unacceptable high levels largely due to the high growth of money supply and depreciating Kwacha, and occasional shocks such as the effects of drought. With respect to monetary expansion, government borrowing from the BoZ has been important. This, in turn, is related to high external debt burden and inadequate donor budgetary support;

vi. Qualification to the HIPC completion point;

vii. *HIV/AIDS*. The challenges of HIV/AIDS on Zambia are obvious. Principally, HIV/AIDS threatens the country's capacity building efforts because it strikes the educated and skilled as well as the uneducated. Consequently it reverses and impedes the country's capacity by shortening human productivity and life expectancy. The long periods of illness of the skilled personnel in employment has translated into severe loss in economic productivity, which leads to considerable loss to the employer in lost man-hours;

viii. *Independence of the central bank*. The weak regulatory framework of the central bank impedes the attainment of greater macro monetary control to effectively control the fiscal policy situation;

ix. *Weak statistical data*. Data on key macroeconomic variables such us GDP tends to be unreliable. This is seen in the inconsistencies between official GDP statistics and observed unemployment levels;

x. Unemployment is omitted from the key macroeconomic variables;

xi. There has been weak economic management, which has led to time inconsistency of economic policies;

xii. There are fears that debt management principles may not be adhered to after reaching the HIPC completion point; and

xiii. There is a mismatch between political direction and economic policy.

2.4 PROGRESS TO DATE

85. Since November 2003, interest rates on government securities have declined sharply. This is attributed to the following factors:

i. The reduction in the statutory reserve ration from 17.5% to 14% in October 2003;
ii. The reduction in Government borrowing; and
iii. The stability of the Kwacha against the US dollar due to the improvement in the external environment.

86. For this trend to in Government securities interest rates to lead to the reduction in commercial bank interest rates, the Government must continue with its commitment to keeping its borrowing within the budget. With negative real interest rates on Government securities, commercial banks will be forced to extend credit to the private sector, which should lead to lower interest rates.

2.5 RECOMMENDATIONS

87. In order to achieve the vision for the financial sector, the following recommendations relating to the macro-economic environment are made:

i. There is need for continued prudential fiscal performance by the Government. Frugal fiscal operations must complement monetary policy in order to create a sound and stable macroeconomic environment that will promote economic growth and development;
ii. Fiscal deficits should be reduced by controlling government expenditure through expenditure reform and increasing tax revenue by broadening the tax base. Additionally, public sector quasi-fiscal deficits caused by losses from the remaining parastatals and other extra-budgetary funds should be reduced or eliminated by commercialising or privatising these enterprises. Reducing these deficits will reduce the public sector borrowing requirement, reduce the upward pressure on interest rates and monetary expansion;
iii. The Government's credit facility at the BoZ should be revised downwards. The amount of funds Government should be allowed to borrow through this facility and the term of the bridge loan need to be reviewed. The current threshold of 15 percent

of the previous year's revenue collections should be revised downwards while the maturity of these bridge loans should be restricted to not more than one month. It is important that Government relies on borrowing from the financial markets at market interest rates so that fiscal discipline is instilled. Such borrowing is also non-inflationary because it does not lead to an increase in money supply. This, however, should be done alongside an increase in participation of the non-bank public in the primary market for government securities to avoid reducing loanable funds in the banking sector;

iv. There is need to attract credible foreign investments so as to augment savings. Foreign investments when carefully selected can also assist to open doors in the export markets and transfer skills and technology;

v. Steps should be taken to ensure that debt relief and pledged donor support is accessed, thus reducing the need of Government to borrow from the BoZ;

vi. A system should be devised to promptly move government revenue from the banking system into the revenue accounts at BoZ to improve Government's cash flow and reduce the need for short-term borrowing from BoZ;

vii. The Government, through the MoFNP and ZRA, should closely work together with the BoZ to provide timely information on the disbursement of funding and the flow of revenue between the banking system and the government accounts at BoZ. This will assist BoZ, in its liquidity management, to determine the appropriate size of daily OMO, thereby smoothening the levels of liquidity in the money market and reducing volatility at the short end of the yield curve;

viii. The Government should intensify its efforts in the development and implementation of the Domestic and External Debt Strategy. Debt should be managed as a single portfolio by one body, being the MoFNP or an independent debt agency;

ix. The Debt management unit at the MoFNP should be strengthened;

x. The Government should devise means of broadening the tax base through such mechanisms as presumptive taxation;

xi. Credibility needs to be built by committing to fiscal and other macroeconomic announcements. Any failure to commit should be explained in good time to pin down any adverse expectations about the credence of policy;

xii. To further enhance policy credibility, there should be separation of responsibilities. Authority on issues of exchange rate, interest rates and monetary developments should be left to BoZ, while those of fiscal performance should be left to the MoFNP;

xiii. The use of the statutory reserve ratio in the monetary framework should be minimised with indirect instruments playing a major role. Further, with the development of the securities markets, BoZ should use repos as the dominant instrument. The advantage of repos is that they are liquid and collateralised;

xiv. To improve the effectiveness of indirect instruments, a market-maker system should be introduced and be specifically tailored for the promotion and development of the secondary market. The development of the secondary market for treasury bills will not only improve the responsiveness of the money market to monetary policy but will also lead to higher demand for these securities and eventually to a decline in interest rates;

xv. Criteria should be put in place to determine which enterprises have the capacity to issue tradable financial instruments such as bills of exchange and acceptances. Criteria to accept these instruments will allow the secondary market to discount them. This will increase liquidity in the market and enhance economic activity;

xvi. The penalties for failing to meet liquidity requirements should be reviewed downward in such a way as to encourage the banking sector to efficiently manage its liquidity while at the same time encouraging inter-bank activity;

xvii. The effective implementation of monetary policy in the face of dollarisation requires the adoption of measures aimed at reducing the dollarisation process. This calls for strong legislation to impose some penalties on business houses and individuals involved in the quoting of the prices of goods and services in a foreign currency;

xviii. The current basket for the computation of the Consumer Price Index (CPI) was last updated in 1994 and could be outdated. The basket of goods used in the computation of the CPI should be updated to reflect current consumer tastes and preferences;

xix. The BoZ Act should be revised to take into account the benefits, which may accrue from greater central bank independence over the conduct of monetary policy;

xx. There is need to mitigate and reduce new infections and the socio-economic impact of HIV/AIDS;

xxi. Ensure periodic undertaking of economic surveys and census. This can be facilitated by making the CSO Board operative from 2005;

xxii. Unemployment should be included as a macroeconomic policy target starting from 2005;

xxiii. To ensure there is no mismatch between political direction and economic policy, the Government should ensure scaling up the consultative process as in the PRSP and MTEF; and

xxiv. To solve the time inconsistency problem of economic policy management, Government should strengthen the economic management team at the MoFNP. In the management of public resources, Government must adhere to constitutional and legal provisions such as the Financial Management Act.

2.6 MEDIUM-TERM MACRO-ECONOMIC OBJECTIVES

88. Government's broad macro-economic objectives for the period 2004 to 2006 include the following:

i. Raise and promote broad based economic growth to at least 5% by 2006;
ii. Reduce inflation to single digits by 2006;
iii. Reduce fiscal deficit to 1.6% of GDP by 2006;
iv. Build international reserves to an equivalent of three months import cover to cushion against external and domestic shocks;
v. Achieve consistent stability of the Kwacha;
vi. Reduce foreign debt by, among other things, reaching the HIPIC completion point;
vii. Continue with the implementation of structural reforms
viii. Reduce the rate of HIV/AIDS infection;
ix. Ensure food security; and
x. Promote gender equality and equity.

3 KEY FINANCIAL SECTOR ISSUES

3.1 INTRODUCTION

89. Zambia's financial sector is at a rudimentary stage, with limited financial intermediation and low public confidence. Zambia still has one of the lowest levels of financial intermediation in sub-Saharan Africa: This chapter offers a global assessment of common sector-wide challenges and recommended solutions

3.2 THE FINANCIAL SECTOR

3.2.1 Financial Institutions

90. Since independence in 1964, the financial sector in Zambia has undergone two notable phases in its development. First, during the early 1970s when the Government's nationalisation program had an important impact upon the sector. Although commercial banks were not nationalised, all other major financial institutions were nationalised and merged to form government owned institutions such as the Zambia State Insurance Corporation (ZSIC) and the Zambia National Building Society (ZNBS). Entry of non-bank financial institutions into the financial sector became restrictive. However, Government established financial, institutions such as the DBZ, the Local Authority Superannuation Fund (LASF) and the Zambia Export and Import Bank, through Acts of Parliament.

91. The second phase of notable change in the financial sector in Zambia has been the liberalisation of the sector, and the economy generally, since 1991. The liberalisation led to the entry of new financial institutions into the industry.

92. The financial sector has grown and now comprises the Central Bank, commercial banks, non-bank financial institutions (comprising the three building societies, some micro finance institutions, the National Savings and Credit Bank (NSCB), the DBZ, the 37 Bureau de changes and leasing companies), insurance companies, pension funds and the capital markets.

93. Despite entry of new financial institutions after the liberalisation of the economy, the Zambian financial system has remained relatively small. The ratio of M2 to GDP has been in the range of 15 –20 percent over the last five years, within the middle range for monetisation ratios of Sub-Saharan African Countries. In the early 1980's, M2 was about

35 percent of GDP. Bank credit- at 8 percent of GDP is-is among the lowest for Sub-Saharan countries and is exceeded by credit to the public sector. Dollarisation is high with about half of bank deposits and one third of loans in foreign currency.

94. The state owned Zambia National Commercial Bank (ZNCB) and foreign owned banks dominate the financial sector. Commercial banks hold about 90 percent of financial system assets and foreign equity participation is significant, accounting for three quarters of the banking system capitalisation. The banking system is comprised of 13 commercial banks. There are five large banks (Barclays Bank, Standard Chartered Bank, City Bank, Stanbic Bank and Zambia National Commercial Bank) four of which are subsidiaries of multinational banks (SMBs). In terms of assets, Barclays is the largest bank followed by the Government bank, Zambia National Commercial Bank (ZNCB), which is in the process of being privatised.

95. The insurance business is very small in Zambia and contributed 1.5 percent of GDP in premiums in 2000. The insurance market is dominated by an insolvent public institution, the Zambia State Insurance Corporation (ZSIC). Since deregulation in 1992, a number of locally registered insurance companies have emerged.

96. The pension sector in Zambia comprises the National Pension Scheme (NPS), which is mandatory for all employees in the formal sector, and supplementary schemes, which are offered by private sector employers. There are over 200 of these independently administered pension schemes, which include both defined benefit and defined contributory plans. The supplementary pension schemes- at about K 360 billion- have the largest assets in the pensions sector, while the NAPSA represents over K 230 billion.

97. There are four other types of non-bank financial institutions in Zambia. These are:

i. Institutions that accept deposits from the public, including the three building societies, some micro finance institutions, and the NSCB;
ii. Leasing companies;
iii. Thirty-seven bureaux de change; and
iv. The DBZ, which previously financed itself from foreign development banks.

98. Government owns three of the non-bank financial institutions namely, the DBZ, the ZNBS and the NSCB.

99. Leasing companies undertake a diverse range of financial services including factoring and trade finance, term lending, corporate finance advisory services, investment

advisory services, corporate restructuring, treasury management as well as traditional leasing activities. Leasing companies are financed largely through donor lines of credit, and the issuance of promissory notes or debentures to institutional investors, notably, the NAPSA.

100. The micro finance industry is relatively new in Zambia and serves a very small percentage of the population.

3.2.2 Financial Markets

101. Zambia's financial markets are thin and largely short term, in part reflecting prolonged periods of high inflation, and volatility in interest rates. The inter-bank market is concentrated in the overnight maturity. The primary market for government securities has been growing rapidly but the secondary market is very small, as banks hold bills to maturity. Interest rate volatility in the inter-bank market has remained quite high. This has been attributed to sharp swings in flows of cash between the government and the private sector.

102. The foreign exchange market is characterized by the concentration of supply in a small number of large exporters and foreign aid. The BoZ has discontinued auctions of foreign exchange at the dealing window on 23 July 2002 and introduced the inter-bank foreign exchange market. This ensures that the exchange rate reflects conditions in the market.

103. The stock market in Zambia is small with a market capitalisation was about US $ 220 million in March 2002, equivalent of 8 percent of GDP, among the lowest of the newly established African exchanges. Even with supportive government policy and donor technical assistance, the stock market has failed to evolve into a viable market. Since its inception in 1994, the number of companies listed on the Lusaka Stock Exchange has grown modestly from 7 to 11. Few make more than 10 percent of their shares available for trading.

104. The major means of retail payment is cash and the payment system is not a source of systemic risk. This is especially true for the rural population, which is not adequately served by the banking system. Cheques are currently the major means of non-cash payments and are cleared at the Zambia Electronic Clearing House (ZECH). The BoZ has made significant progress in modernising the payments system in Zambia.

105. There is no formal deposit safety net in Zambia. However, banks facing difficulties have resorted to credit lines from the BoZ. The BoZ is considering the introduction of a formal deposit insurance scheme.

3.2.3 Legal and Regulatory Framework

106. The BoZ is the supervisory authority in Zambia for banks and non-bank financial institutions. It has responsibility for supervising banks, development financial institutions, leasing companies, building societies, and micro finance institutions. The two other supervisory agencies are the Securities and Exchange Commission (SEC) and the Pension and Insurance Authority (PIA).

107. The BoZ Act and the Banking and Financial Services Act (BFSA) provide a legal framework for the central bank to carry out its supervisory responsibilities.

3.3 HUMAN RESOURCES

108. The financial sector in Zambia recognises that its employees are the most valuable of its assets and that the successful attainment of its ambitions is directly related to the quality of staff, their expertise and commitment.

109. There are a number of institutions that play a role in the development of human resources for the financial sector in Zambia. These include universities, accountancy/business colleges, commercial banks, the Zambia Institute of Bankers (ZIOB), regional institutions of learning and non-governmental bodies. However most of these institutions lack adequate capacity to bridge the skills and knowledge gap.

110. The Government is committed to the promotion of an equal opportunity work environment and capacity building in ministries, quasi government organisations, on-governmental organizations and the private sector. It also recognises that the support of co-operating partners is critical in addressing the constraints and the attendant issues including HIV/AIDS in the effective operation of a market-driven economy.

3.3.1 Objective

111. 'To promote and fully utilise the skills, knowledge, personal development and the enthusiastic commitment of all staff'.

112. Commonly shared resourcing, development and retention strategies are critical vehicles for developing individual employee effectiveness consistent with the financial sector's strategic goals.

3.3.2 Constraints and Issues

113. The following have been identified as the major impediment to the development of a sound financial sector:

i. *Capacity Building:*

- *Quality of Education*: While some institutions can supply qualified graduates more often than not, the graduates have to be turned into competent workers. This requires customised training of international standards. Local institutions are unable to fully fill this gap.
- *Funding for tertiary education*: Inadequate local support for capacity building with a view to improving the scope and quality of training services available.
- *Compliance of educational standards:* Weak enforcement of compliance of the educational standards, for instance, forged educational certificates, examination leakages and credibility of some qualifications.

ii. *General Human Resources Management*

- *Resourcing and development approaches*: Lack of a unified approach to staff recruitment, training and development and retention activities within the financial sector's strategic posture;
- *Health, safety and environmental issues:* Lack of viable workplace policies by some financial institutions to manage the HIV/AIDS pandemic.

3.3.3 Progress Made to Date

i. Capacity Building

- A lot of training intended to raise the competence mix in both the regulatory authorities and commercial financial institutions.
- Funding for tertiary education.

- A few institutions have received financial support especially from donors. The majority still need a lot of resources to improve the scope and quality of training services available.
- There is some enforcement by relevant institutions in terms of licensing of education providers and certification.

ii. *General Human Resources Management*

- *HIV/AIDS*: Some financial institutions have put in place viable policies to manage the pandemic

3.3.4 Recommendations

i. Realign labour and immigration laws to promote affirmative action by protecting local labour by third quarter 2006;
ii. Establish a standardized framework of aligning staff recruitment, training and development and retention activities with the financial sector's strategic posture by the year 2005;
iii. All staff should possess minimum academic/professional requirements and be required to be members of relevant professional bodies immediately;
iv. Develop workplace HIV/AIDS policies to preserve vital institutional memory (people & information);
v. Develop a comprehensive Communal Personal Information System (CPIS) as an extensive database on both the JOBS and PEOPLE including modules on turnover of staff, training management, career management and establishment throughout the sector by second quarter 2006;
vi. Financial institutions to provide internship opportunities for trainees last quarter 2005;
vii. Require the financial institutions to contribute to the provision of opportunities in higher institutions of learning on grounds of good corporate citizenship. This may be through scholarships or payment of a specified levy on the lines of the fuel and medical levies to supplement the government's efforts in running learning institutions. In addition, tertiary institutions of learning should be de-politicised and private sector participation in funding these institutions should be encouraged by last quarter 2005;

viii. Set up Matching Educational Grant Schemes for human resources development in priority areas of financial sector competency by last quarter 2005; and

ix. Strengthen the relevant institutions of learning so that they can provide training that is appropriate to the ever-changing needs of the financial sector. The new areas requiring training to promote local capacity include by first quarter 2006:

a) Good corporate governance;

b) Money and capital markets operations

c) Alternative Dispute Resolution

d) Actuarial and fund management

e) Investment and corporate banking

f) Treasury management

g) Operation and management of micro finance and rural banking

h) Forensic accounting and investigation;

i) Detection and prosecution of commercial crimes;

j) Marketing; and

k) Financial regulation.

3.4 CORPORATE GOVERNANCE

114. Corporate Governance refers to the manner in which the power of a corporation is exercised in the stewardship of the corporation's total portfolio of assets and resources with the objective of maintaining and increasing shareholder value with the satisfaction of all stakeholders (employees, suppliers, customers, society) in the context of the corporate mission

3.4.1 Objectives

115. Good corporate governance aims to promote:

i. Efficient, effective and sustainable corporations that contribute to the welfare of a society by creating wealth, employment and solutions to emerging challenges
ii. Responsive and accountable corporations;
iii. Legitimate corporations that are managed with integrity, probity and transparency;
iv. Recognition and protection of stakeholders' rights; and
v. An inclusive approach based on democratic ideals, legitimate representations and participation.

116. Corporate governance for the Zambia's financial sector has largely been weak. This is because the good corporate governance practices have not yet been fully embraced.

3.4.2 Constraints and Issues

117. Although some good corporate governance principles have been provided by the Companies Act, the Securities Act and Stock Exchange Listing Requirements as well as the Banking and Financial Services Act, the principles therein are not exhaustive and their enforcement leaves much to be desired. As a result there is:

i. Lack of quality boards in a number of corporate bodies;
ii. Prolonged existence of interim boards;
iii. Some inappropriate shareholding structures;
iv. The anomalous phenomenon whereby the same individuals are present on several boards;
v. Prevalence of non separation of powers of Board Chairpersons and Chief executives;
vi. Lack of transparency in the appointment and removal of Directors and Chief Executives;
vii. Weak legislation in managing private and public sector companies' disclosures;

118. The Companies Act has only made provision for the following:

i. Accountability and responsibility of the Board of directors to the shareholders through the requirement to generate, maintain and present annually to members audited annual financial statements.
ii. Shareholders rights on the appointment of directors and auditors.
iii. Shareholders meetings as the supreme corporate body vested with powers to make major decisions of the company.

119. The Securities Act, which only applies to public companies and other entities that issue tradable securities, reinforces the Companies Act on corporate governance, particularly on the financial accountability of the Board of Directors to shareholders and the disclosure of other prescribed price-sensitive information.

120. The Banking and Financial Services Act, which only applies to banks and financial institutions requires the Board of Directors to be accountable not only to shareholders, but to stakeholders (depositors) and to the BoZ

121. Although the LuSE Listing Rules require listed companies to adhere to a code of corporate governance and to disclose in annual reports the extent of compliance with the code the said code is yet to be adopted.

122. Lack of legislation on the enforcement of Good Corporate Principles;

3.4.3 Progress Made to Date

i. Establishment of the Institute of Directors;
ii. Some training of Boards and management in both the private and public institutions;
iii. Amendment of the BFSA on the:
    a. need for majority non-executive directors on boards;
    b. screening of shareholders, CEO and CFO by the BOZ; and
    c. cap of 25% shareholding in financial institutions.
iv. Some draft strategy documents to promote good corporate governance in financial institutions.
v. Shareholding structures

3.4.4 Recommendations

i. Develop code of good corporate governance for all the financial market licensees and participants, which must prescribe the best practice principles to be followed;
ii. Facilitate adoption of good corporate governance principles by encouraging institutional investors to invest in companies that observe good corporate governance structures;
iii. Conducting training programmes to inculcate good corporate governance principles; and
iv. Strengthen legislation to facilitate enforcement of good corporate governance principles.

3.5 LEGAL INFRASTRUCTURE

123. The Zambian legal system is founded on English common law and principles of equity applied by English courts, complimented and varied in some aspects by a series of statutes passed by the Zambian parliament since independence. The legal infrastructure incorporates a judicial system, which comprises the Supreme Court, the High Court, an Industrial Relations Court and lower courts.

124. Whereas a number of legislative changes have taken place under the English Acts, the Zambian laws have tended to stagnate and not respond to the changes in the socio-economic environment.

125. Prior to 1991, there were no notable developments in the legal and regulatory framework of the financial sector. This was largely due to public sector-led policies that did not favour private initiative.

126. After 1991, the Government embarked on an Economic Reform Programme, which necessitated the reform of the legal and regulatory frameworks of the financial sector. However, a limited number of amendments to existing legislation to address new areas of financial sector operations and the strengthening of the existing legal and regulatory framework were effected.

3.5.1 Constraints and Issues

127. The legal and judicial system is unsatisfactory in many respects, with shortcomings such as the following.

i. Delays in delivering judgments due mainly to the workload;
ii. The lengthy process in the disposal of court cases;
iii. Lack of reported judgements;
iv. Infrequent revision of the laws;
v. Bureaucratic procedures leading to delays in the enactment of new laws;
vi. Fragmented laws relating to the financial sector;
vii. Lack of guidelines and directives under principal Acts;
viii. Lack of adequate legal framework for regulating foreign currency transactions;
ix. Lack of financial sector consumer protection laws;
x. Inadequate skills for enforcement of the law relating financial crimes; and
xi. Tendency not to report financial crimes to the relevant law enforcement agencies.

3.5.2 Progress to date

i. A law review committee has been formed within the BoZ
ii. A law review exercise to identify financial sector legislation that requires to be harmonised, repealed or consolidated has been commenced.
iii. Draft anti-money laundering directives have been submitted to the Anti-Money Laundering Investigations Unit.
iv. Draft National Payment Systems Bill has been submitted to the Ministry of Finance for the legislative process.
v. Draft Micro-finance Regulations are about to be submitted to the Ministry of Finance for the legislative process.

3.5.3 Recommendations

i. Improve justice delivery system through adequate staffing and training;
ii. The judiciary should recruit full-time staff to deal with law reporting;
iii. Publication of law reports should be liberalised;

iv. Encourage the use of ADRs mechanisms in resolving commercial disputes;

v. Reform and develop the laws relating to the financial sector;

vi. Streamline the procedures for law reform and development;

vii. Harmonise the laws relating to the financial sector including:

a) Banking and Financial Services Act
b) BoZ Act
c) Companies Act
d) Insurance Act
e) Securities Act
f) Building Societies Act
g) National Pension Scheme Act
h) Societies Act
i) Co-operative Societies Act
j) The Accountants Act

viii. Strengthen the corporate governance provisions in the laws relating to the financial sector including whistle-blowing;

ix. Pass the necessary regulations to give effect to the Prohibition and Prevention of Money Laundering Act number 14 of 2001;

x. Enact specific legislation on insolvency, liquidations and winding up of companies, bodies corporate registered under the Societies and Co-operative Societies Act that are engaged in the financial sector or in the alternative strengthen provisions of existing laws;

xi. Enact financial sector consumer protection laws;

xii. Review of criminal legislation and provisions that provide for the enforcement of regulatory powers;

xiii. Issue or pass appropriate regulations and directives to support principal Acts;

xiv. Identify and implement consistent and sustainable method of funding the judiciary;

xv. Enact a law to prescribe how banks, financial institutions and tourist enterprises should handle foreign exchange transactions;

xvi. Enact a law that will regulate or govern the use or misuse of computer technology in financial and other business transactions; and

xvii. Establishment of a permanent law review committee to address harmonisation and review of various financial sector laws.

3.6 ACCOUNTING AND AUDITING STANDARDS

128. In Zambia, the profession of accountancy is governed and regulated by the Accountants Act of 1982, which provides for the regulation of the education and training of accountants and advancement of accountancy and allied subjects. The Act also caters for regulation and control of the practice of accountancy in Zambia.

129. The Act, established the Zambia Institute of Chartered Accountants (ZICA), whose function has been to register accountants, licence and regulate auditing, monitor and enforce disciplinary measures against erring accounting firms and individual members of ZICA.

130. The enforcement of the Accountants Act is facilitated by the ZICA constitution and the code of ethics. The ZICA Council, as a supreme governing body, and its sub-committees are responsible for the running of ZICA. ZICA is a self-regulating institute, as all members of the ZICA Council (with the exception of two Government appointed ex-official) and its Sub-Committees are registered accountants and any vacancies on the Council or committees are filled through elections.

131. Under the Act, ZICA is also responsible for the advancing of accounting education, provide accounting qualifications by examination and accredit foreign accounting qualifications (in appropriate membership grades of ZICA).

132. The accounting profession is further subject to the provisions of the Companies Act, which requires accounting standards to underpin the preparation of financial statements. The Act also requires that the financial statements of public companies are audited and provides for both the qualification/disqualification of auditors.

133. However, the practice of accounting is characterised by the existence and adoption, by business entities, of different accounting standards frameworks. The adoption of a particular accounting standard is usually driven by the domicile and reporting requirements of the holding companies or sponsors. Despite the apparent existence of several accounting standards in Zambia, such as those issued by the Financial Accounting Standards Board in the United States, the Accounting Standards Board in the United Kingdom and International Accounting Standards Board, the ZICA has no legal power to impose any particular accounting standards to underpin the preparation of financial

statements. ZICA only encourages its members to adopt accounting standards it has adopted.

3.6.1 Objectives

i. Provision of services of consistently high quality;
ii. Standardization of accounting practice will enhance market discipline by encouraging transparent reporting;
iii. Easier comparability or assessment of financial condition and performance;
iv. Protection of the general public when investing in savings, stocks and shares; and
v. Interdependence of financial markets requires accurate and transparent financial reporting.

3.6.2 Constraints and issues

134. The present Companies Act and the Accountants Act lack express power for the respective regulatory authorities to impose any particular accounting standards to underpin the preparation of financial statements or expression of opinions thereon.

135. The ZICA-approved accounting or auditing standards are only applied through moral suasion. However, since not all members of ZICA may be in positions of influence, the application of any ZICA approved accounting or auditing standards suffers from lack of mandatory application.

136. The application of different accounting or auditing standards by business entities, has lead to a significant limitation in the comparability of the financial condition and performance of business entities.

137. Another constraint is that the accounting profession is largely self-regulating, with some members on the Disciplinary Committee of ZICA holding senior positions in accounting/auditing firms. This has made it difficult for ZICA to investigate and punish accounting or auditing failure by registered accountants/firms.

138. The Banking and Financial Services Act (BFSA) has no express provision placing reporting duties on the external auditors to report to the BoZ immediately on the breaches of the law or regulations, concerns about management’s competence, matters of material significance, issues of going concern and any qualification in their audit opinion.

3.6.3 Progress to Date

i. ZICA adopted the International Financial Reporting Standards, the International Accounting Standards and the International Standards on Auditing in August 2003. However, the adoption takes effect from 1st January 2005.

ii. ZICA has revised the Accountants Act to include protection of accountants for whistle blowing, an easily accessible complaints procedure, the publication of disciplinary committee decisions, issuing of the code of ethic under a Statutory Instrument and the mandatory registration of accountants. The draft Bill has been submitted to the Ministry of Finance and National Planning.

3.6.4 Recommendations

i. Given the importance of accounting and auditing system in Zambia the Government (GRZ) should to expedite the promulgation of International Financial Reporting Standards issued by the IASB and International Auditing Standards issued by the International Federation of Accountants into the Companies Act;
ii. The Government should expedite the enactment of the revised Accountants Bill;
iii. The review of the BFSA should include a provision to place an obligation on the external auditors to report to BoZ on the breaches of the law or regulations, concerns about management's competence, matters of material significance, issues of going concern and any qualification in their audit opinion; and
iv. ZICA should enhance its enforcement capacity to improve financial institutions compliance to the Accountants Act, Companies Act and the ZICA ethics.

3.7 REGULATORY STRUCTURES

139. Financial regulation and supervision in Zambia has, over the last decade, been structured around specialist organs and apart from the BoZ, most were established after the liberalisation of the economy in 1991.

140. The enactment of the BFSA, Securities Act, the Pension Scheme Regulations Act and the Insurance Act and related legislation have resulted in distinct and separate

regulatory responsibilities for the banking, securities, pensions and insurance sectors. The main regulatory organs that have emerged in the financial sector are:

i. Bank of Zambia;
ii. Securities and Exchange Commission;
iii. Pensions and Insurance Authority;
iv. Zambia Competition Commission; and
v. Patents and Companies Registration Office.

141. There exist a number of overlaps and areas of conflict in the regulatory environment of financial services in Zambia leaving room for regulatory arbitrage and bureaucratic tendencies to creep in. Technological improvements and globalisation have resulted in the emergence of complex financial structures which have blurred the traditional product boundaries among the banking, securities and insurance sectors as products and financial service activities are becoming more integrated.

142. The structure of the financial services sector throughout the world is undergoing dynamic changes with changing operational framework on markets and of the attendant risks, which have resulted in more innovative risk management techniques.

143. In the light of the above changes, there is a view that a single integrated body responsible for overall supervision would create an enabling environment for better convergence of policies by bringing all regulatory functions together in a harmonious manner. Compared with single specialist regulatory agencies, the merit of the integrated approach is the lower likelihood of specific regulatory gaps within the same or different regulatory jurisdictions.

144. The issue of whether to have separate specialist bodies or a unified supervisory agency and the manner in which the integrated regulatory body would be structured and managed and how to implement and manage the integration process and at what point a country should consider a shift to a unified body continues to be debatable.

145. Technological advances and the associated extensive use of new technology and related practices, inter-linkages, globalisation and inter-dependence of the banking, securities, pensions and insurance sectors pose challenges for economic policy issues and a coherent structural reform and timely response from the policy makers to address this is cardinal at this stage of the development of the Zambian financial sector.

146. So far in Zambia, reforms and updating of the legislations have been ad hoc and piecemeal as can be seen by the many un-coordinated reviews such as the on-going reviews of the laws. There is a need for coordination in the harmonization of the various pieces of legislation.

3.7.1 Constraints and Issues

147. Below is an illustration of some of the areas of overlap in the regulation of institutions and asset classes, which have resulted in their being subjected to multiple regulatory regimes:

i. *Commercial banks* – the main regulator is the BoZ but there have been cases where the banks have been involved in the issue of Corporate Bonds as recently undertaken by Barclays Bank, which involved and will continue to involve the Securities and Exchange Commission as well as the provision of custodial services.

ii. *Merchant banks* – the merchant banks such as Cavmont Merchant Bank and Investrust Bank (before it changed its name) have largely operated as commercial banks with very little fee income generated from advisory or underwriting services provided. As such, they have tended to be regulated by the BoZ and only when they are involved in the floatation of securities have they attracted the SEC's intervention.

iii. *Discount houses* – are mainly regulated by the BoZ but their recent involvement in collective investment schemes have had to bring them under the ambit of the SEC.

iv. *Pension Funds* – pension funds were for a long time unregulated until the Pension Scheme Regulations Act came into being in 1996. The Act is flawed and has a lot of areas that require streamlining. Prior to its enactment, pension schemes were only required to register with Zambia Revenue Authority for tax exemption purposes but their operations were largely unregulated. With the establishment of the PIA there is now some limited supervision being undertaken albeit ineffectively due to the limited capacity of the regulatory body itself. Areas of conflict exist in the pensions arena, as there are multiple regulators and organs concerned with the management of pension funds. For example, the current Pension Scheme Regulations Act does not provide for specific regulation of statutory bodies such as LASF, NAPSA and the Public Service Pensions Fund and only does so in as far as prudential fund management principles are concerned. The PSPF, for example, reports into the Office of the President which is a superior body compared to the regulator, the PIA, which only operates as a department of the Ministry of Finance which set up poses a lot of supervisory and operational problems for the PIA.

v. For fund management functions the relevant organs are the PIA, SEC, ZRA and to some extent the BoZ. For scheme management there is also the involvement of the Ministry of Labour and Social Security and the Ministry of Lands for the registration and incorporation of Trust Deeds under which the schemes operate.

vi. *Insurance companies* – are ordinarily regulated by the PIA. However some of their products such as ZSIC's Swiftsave savings scheme attracted SEC's intervention.

vii. *Building Societies* – by their very nature are supposed to be involved in long-term housing finance and mortgage products such as long-term bonds, which are the preserve of the capital market regulators such as the SEC but recently building societies have been brought under the supervision of BOZ in a manner that is not fully structured.

viii. *Collective Investment Schemes (CISs)*– by their nature CIS's are a capital market product and thus subjected to SEC regulations. Increasingly, because of the need to have some of these products as approved areas of pension fund investment, this has attracted the PIA.

ix. Securities business for brokers and the Lusaka Stock Exchange among others are still under SEC. Secondary trading of Government Bonds on the LuSE, also presents another area of potential conflict because of the involvement of BOZ who are the primary issuers.

x. *Development Financial Institutions* – these were unregulated and it is only recently that institutions such as DBZ have come under the BOZ supervision although the supervisory framework is yet to be developed.

xi. Venture Capital Funds / SME/ or private equity and investment advisory services have generally been unregulated apart from the need for them to register with SEC

148. As a result of serious overlaps and conflicts in the existing law applicable to the financial sector, the operations of the following bodies pose regulatory challenges: building societies, NSCB, DBZ and venture capital funds (including Zambia Venture Capital Fund, the SME fund recently launched by KCM and Cavmont-FMO Fund).

149. Asset management companies and companies providing investment advisory and other financial services are subject to conflicting regulatory regimes giving rise to regulatory arbitrage .

150. Annuities businesses, which are supposed to be a function of insurance companies, are still being undertaken by pension houses in Zambia.

151. Commercial Credit Institutions including moneylenders have no proper regulations or supervision of their activities undertaken by any specific regulatory agency.

3.7.2 Recommendations

i. Pass appropriate legislation to facilitate integration of the financial sector;
ii. Undertake a study to review the current regulatory structures to identify the most appropriate regulatory model that mirrors the evolving business structures of financial institutions in Zambia.

3.8 FINANCIAL SAFETY NET

152. The stability of the financial sector is cardinal for the efficient functioning of the economy. Banks form the largest and most important component of the financial system and in most third world countries provide the only channel for financial intermediation.

153. The Zambian financial system has been faced with a serious threat of financial instability due to the failure of a number of financial institutions over the last 12 years. This has been of great concern both to the BoZ and the government because of the numerous adverse effects that these failures have had on the financial sector and the economy as a whole. These include:

i. Erosion of confidence in the financial sector, especially in the indigenous financial institutions. This has resulted in the shifting of deposits from indigenous banks to foreign or state-owned banks which were perceived as being safer because of strong parent support, in the case of foreign-owned banks, and implicit government guarantee in the case of government-owned banks;
ii. *Unplanned government expenditure*. Bank failures have cost the government an estimated K110 billion;
iii. Loss of customer deposits resulting in suffering, especially among personal depositors; and

iv. Disruption in the payment system caused by the temporary loss of transactions media, disruption to the orderly conduct of business due to the breaking of pre-established lines of credit and other business relationships.

154. In order to address these issues, most countries have established financial safety nets aimed at increasing the safety and stability of the financial system and to boost confidence in their financial system. A financial safety net consists of three pillars namely deposit insurance, the lender of last resort function, regulation and supervision. These pillars operate together to provide an institutional framework that is aimed at stabilising the banking system by preventing bank runs and, where they occur, protect and minimise the losses suffered by depositors.

3.8.1 Legal infrastructure

155. Currently, Zambia only has a well functioning bank regulation and supervision structure. However, the lender of the last resort function is not well defined. Deposit protection has been recognised as the missing link in the safety net which when introduced, would help resolve some of the problems arising from bank failures. It must be noted that in jurisdictions were entry into the banking system is limited, the economy is static and prudential regulation of banking activities is strong, there may be no need for deposit protection.

156. As regards the lender of last resort function, until recently, the BoZ had no laid down policies or procedures in place that guided whether, when and under what conditions support would be given to financial institutions in distress. Neither was there an attempt to determine whether there was, in fact, a systematic threat. The situation was exacerbated by the fact that the clearinghouse rules were fairly lax in the need for banks to have sufficient collateral to be permitted into clearing.

157. Zambia currently does not have a deposit protection fund and there is no supportive legal framework in place.

158. Arising from Zambia's experiences with financial institutions failures, the BoZ, in consultation with other major stakeholders, has been looking into the establishment of a deposit protection scheme. To this end, the BoZ has come up with draft legislation for consideration and possible adoption into law by Parliament.

159. The BoZ's authority to act as lender of last resort is contained in section 42(3) of the BoZ Act of 1996. Section 42(1) authorises the BoZ to operate accounts for banks and other financial institutions on such terms and conditions as the Board may determine. The Act provides for the Bank to lend to such account holders where it feels it is necessary to meet liquidity requirements or 'forestall insolvency to safeguard the financial system.' This lending can be on such special terms and conditions as the Board may determine and may or may not be secured. The Act further provides for the granting of secured advances for a period not exceeding six months. The security obtainable for such advances is specified in section 42(2)(b)(i) (iii).

160. It can be seen that the provisions of the Act gives the BoZ a great deal of discretion and flexibility in terms of granting advances to financial institutions. To date, BoZ has granted advances to a number of banks at various times. Some of these banks have since been placed under curatorship, receivership or liquidation.

3.8.2 Constraints and Issues

i. The lack of central bank independence has resulted in recommendations and decisions made by the BoZ being overridden by the Ministry of Finance and National Planning. This has been a major contributing factor to the manner in which BoZ has exercised its lender of last resort function and consequently, the losses it has had to sustain.
ii. Absence of mechanism for assessing whether a bank closure would result in a systematic crisis warranting BoZ assistance.

3.8.3 Recommendations

3.8.3.1 Deposit Protection

161. Enact the Deposit Protection Bill for eligible deposit-taking financial institutions.

3.8.3.2 Lender of Last Resort

i. Codify into law rules to guide BoZ's intervention in the bank industry. This will enable the BoZ to take prompt corrective action and reduce the effects of regulatory forbearance. Making supervisory responses mandatory limits supervisory discretion and offsets the pressure on bank supervisors to delay prompt corrective action.

ii. *Nature of Support to be given:* The nature of support to be given should be broadly classified into three types:

a) *Preconditions for overnight facility*

Overnight facility:	banks are provided with support in situations where they face shortfalls resulting from the miscalculations of liquidity requirements, for instance:
Short-term facility	support given to banks facing funding problems on a short-term basis;
Long-term facility	support given to banks whose funding problems are not of a short-term nature

162. The following preconditions are recommended for each of the above facilities.

b) *Preconditions for short-term facility:*

(1) The failure of the bank would pose a systemic threat;
(2) The bank is capital solvent;
(3) The bank has adequate collateral;
(4) The bank has exhausted all other means for meeting it's funding needs;
(5) The shareholders have reasonable attempts to provide liquidity support as a sign of their commitment to the bank;
(6) Management is considered fit and proper;
(7) The banks' liquidity problems are not due to management fraud and
(8) The Bank has a viable plan to deal with its liquidity problem.

163. For the short term facility, the support should be provided for an initial term not exceeding thirty days for instance with a provision to roll over for another thirty days if necessary. This period should provide sufficient time for the BoZ to do a due diligence study and enable it to assess whether it is likely that the institution will be able to resolve its liquidity problems. If not, BoZ should prepare a course of action to be followed if the institution is found to be insolvent. Like in the case of overnight

164. facilities, support should be given at an interest rate sufficiently high to encourage the banks management to resolve its problems but not too high that it would be too costly for the bank and may cause it to become insolvent.

c) *Preconditions for the long-term facility:*

165. For the long-term facility, some of the pre conditions listed above may not apply. For example, the institution will most probably be capital insolvent and may not be able to provide sufficient collateral. For this type of facility, more discretion is likely to be used. The overriding factor in making these decisions in these circumstances should be the implications of the bank's failure on systemic stability.

iii. *Central Bank independence*: The BoZ should have operational independence because as long as its decisions can be overridden by a higher authority, it will most probably continue to sustain losses in exercising its role of lender of last resort.

3.9 REGIONAL INTEGRATION

166. Africa faces multiple challenges ranging from poverty, poor health care, civil war and other types of political conflict. Additionally, Africa is the most sub-divided continent with 165 borders dividing the 51 countries. The international community has taken cognisance of this and has undertaken to tackle the numerous developmental issues affecting the continent. Increasingly it has been felt that regional integration will provide the panacea to accelerate Africa's development. According to the Economic Commission for Africa and the World Bank, a regional integration approach to development is likely to increase the competitiveness and growth of African economies by improving economies of scale. It is also likely to maximize its integration with the global economy, create strong institutions to tackle regional conflicts and create an enabling environment for accelerated development of business activities. A regional integration approach may also lead to the creation of a strong, institutional capacity to address political problems in the continent.

167. Zambia is a member of the Southern African Development Community, a community consisting of 13 countries and, whose ultimate objective is to build a region in which there will be a high degree of harmonisation and rationalisation of systems to enable the pooling of resources to achieve collective self-reliance in order to improve the living standards of the people of the region.

168. The Objectives of the Community as stated in the Treaty are to:

i. Achieve development and economic growth, alleviate poverty, enhance the standard and quality of life of the peoples of Southern Africa and support the socially disadvantaged through regional integration.
ii. Evolve common political values, systems and institutions.
iii. Promote and defend peace and security.
iv. Promote self-sustaining development on the basis of collective self-reliance, and the inter-dependence of member states.
v. Achieve complementarities between national and regional strategies and programmes.
vi. Promote and maximise productive employment and utilisation of resources of the region.
vii. Achieve sustainable utilisation of natural resources and effective protection of the environment.
viii. Strengthen and consolidate the long-standing historical, social and cultural affinities and links among the peoples of the region.

169. Zambia is also a member of the Common Market for East and Southern Africa an organisation consisting of 21 member states whose overriding objective is economic prosperity through regional integration.

170. With particular reference to the financial sector and in order to achieve the objectives of these two bodies, there have been a number of initiatives in the integration in the financial systems of the member countries of these bodies and a number of committees have been formed to oversee this process. These include:

i. The Committee of Insurance, Securities and Non- Bank Financial Authorities;
ii. The SADC Committee of Central Bank Governor;
iii. SADC Committee of Stock Exchanges;
iv. The SADC Committee of Supreme Audit Institutions; and
v. Committee of Bank Supervisors in the COMESA region.

171. The initiatives under the Committee of Insurance, Securities and Non- Bank Financial Authorities can be summed up to include market development, market integration and systemic risk and their development agenda is envisaged to be at two levels.

i. Coordinate an assessment of every member's legal and regulatory framework and practices in terms of the IOSCO objectives and principles through self-assessments and verified by peers to identify improvements that need to be made; and
ii. Assess the level of development of the various constituent elements of capital markets, insurance and retirement funds in each member country. This would include product availability, level of competition and depth of barriers to development.

172. The Committee of Central Bank Governors has equally made strides in achieving integration and harmonisation of standards and practices in the financial sector. The BoZ has just commissioned Bank Supervision Applications, a project which is designed to achieve the vision of a sound and harmonised legal framework, an internationally accepted minimum reporting, disclosure and prudential standards and a common and effective enforcement measures.

173. Zambia has also completed a National Payment System vision, whose objective is to facilitate global and regional integration and provide a secure domestic payments system for the country. This fits into the both SADC and COMESA's vision of free trade and cross border payments. Under the SADC Payment System Project, the Committee of Central Bank Governors recommended a suitable Interbank Settlement System for SADC members. This will be based on Real Time Gross Settlement System (RTGS) and is supposed to be commissioned in 2004. The COMESA Cross Border Payments vision envisages a regional payment system, which is premised on the basis of RTGS. It is in line with these that Zambia is in the process of introducing the Zambia Inter bank Payment Settlement System, which is also based on RTGS.

3.9.1 Constraints and Issues

i. Potential difficulties in managing the wide variations in the socio-economic development of African nations;

ii. Different levels of development in infrastructure among members in the financial systems of member countries. This poses challenges in synchronising the architecture in the different financial systems;
iii. Different laws obtaining in the different countries may prove to be a hindrance in effective integration in various sectors of the financial sector;
iv. Lack of resources among some member states to create and sustain regional structures and mechanisms;
v. Competing demands brought about by belonging to more than one regional economic grouping; and
vi. Weak capacity at national level to implement regional protocols.

3.10 PREVENTION OF MONEY LAUNDERING

174. The Prohibition and Prevention of Money Laundering Act 2001 (PPMLA) was promulgated in the year 2001. The Act provides for the creation of an Anti-Money Laundering Authority to be chaired by the Attorney General and an Anti-Money Laundering Investigations Unit (the *Unit*) to be chaired by the Commissioner (who is a member of Anti-Money Laundering Authority). The Act defines that the Commissioner is a person appointed as Commissioner under the Narcotic Drugs and Psychotropic Substances Act.

175. As per the Act, the Anti-Money Laundering Authority is required to provide general and specific policy directives to the Commissioner and the Commissioner has to give effect to such directives as one of its functions. The Unit has several functions. Apart from its main function of collecting, evaluating, processing and investigating financial information received from the regulated institutions, it has to assist in developing training programmes for use by regulated institutions and Supervisory Authorities in implementation of the Act, to supervise reporting requirements and other administrative obligations imposed on the regulated institution and Supervisory Authorities.

176. Almost two years have passed since the said Act was promulgated, and progress has been slow. The Anti-Money Laundering Investigations Unit has now been established under the Drug Enforcement Commission (DEC).

177. In addition to the inertia in establishment of the various functional arms of the Money Laundering Authority, appropriate steps have not been taken in educating the

general public/creating public awareness about money laundering activities. The Unit has also not yet come up with appropriate training programs through which the regulated institutions can impart training to its staff members in mechanisms for preventing money laundering, techniques in the recognition and handling of business transactions carried out by or on behalf of any person who is or appears to be engaged in money laundering activities.

178. The Act provides that a regulated institute shall report to the unit any transaction, which gives "reasonable grounds to believe that a money laundering offence is being, has been or is about to be committed". The expression "reasonable grounds to believe" leaves considerable room for interpretation and therefore, the ground staff at the regulated institutes have become vulnerable to the various provisions of the Act.

179. The Act, though requires reporting to be made, does not specify any threshold beyond which the transactions have to be reported. The Act does not specify any format in which reporting is to be made. The Unit / Supervisory Authorities have yet to come out with any such format. There is no doubt that the suspicious transactions irrespective of any limit/threshold need to be reported. However, to enable the Unit to investigate the transactions, considering that ours is a cash economy, it is required that the Unit should also gather information on transactions beyond a threshold and that too in a standardized format.

180. As ours is a cash economy, majority of the transactions are performed in cash and in the absence of any centralized database of suspected persons, absence of any mechanism to establish true identity of the documents submitted for identification, there is a general feeling amongst the operating staff that they may be unfairly singled out by the Unit for failing to enforce various provisions of the Act. Moreover, the ground staff is under fear that they may attract lawsuits if they disclose the information about customers' transactions to the Unit in the absence of specific protection offered under the Act. The provisions of section 14 of Act viz. "it shall not be unlawful for any person to make any disclosure in compliance with this Act" are seen inadequate in this regard.

181. The Supervisory Authorities are expected to issue appropriate directives in the prevention of money laundering activities to the regulated institutions they regulate. They are also required to report to the Unit the information relating to financial and other business transactions suspected to be part of money laundering. This requires that the

Supervisory Authorities should have a mechanism developed to collect such information. However, most Supervisory Authorities have yet to issue such directives and establish a mechanism for gathering such information.

182. The BoZ however is in the process of drafting such regulations for the banking and non- banking sector and these are expected to be in place in 2004.

183. The BoZ in 1998 issued guidelines on the "customer identification". The banks and other players in the financial sector have taken steps in implementing these guidelines and also the provisions of Act on their own. However, the absence of policy guidelines and regulations and weak enforcement by the BoZ, the steps being taken by banks on their own may prove non-effective in prevention of the money laundering activities.

184. It is also recognised that there is no proper co-operation among the Supervisory authorities. Information and data on persons involved or suspected to be involved in money laundering activities should be shared by the players in the market.

185. In the absence of a centralized database of person/s involved/suspected to be involved in the money laundering activity, the players in the market are vulnerable to the risk of opening accounts of such persons.

186. FATF's eight special recommendations on terrorist financing need to be incorporated in the Act to become fully compliant in this regard.

3.10.1 Constraints and Issues

187. The supervisory authorities have not yet put in place the necessary mechanism for issuing appropriate policy guidelines and directives to financial institutions. Further, education and consumer awareness of the adverse effects of money-laundering is still low

3.10.2 Recommendations

i. All supervisory authorities should set up a separate internal unit specifically to deal with/address all issues relating to the prevention of money laundering activities and for effective implementation of the various provisions of the Act. The supervisory authorities should, in addition, issue appropriate guidelines/regulations for their various jurisdictions and ensure that the institutions they supervise comply with the regulations and the provisions of the Act;

ii. The supervisory authorities should, in consultation with the regulated institutions come up with a threshold limit and reporting format;

iii. The Unit to come up with appropriate training programmes incorporating techniques in recognition and prevention of money laundering activities, common documentation and methods of imparting training so that individual regulated institute could conduct training to its staff members. Such training should be a continuous one;

iv. FATF's 8 special recommendations on Terrorist Financing need to be incorporated in Act to ensure full compliance;

v. The Unit and supervisory authorities (along with individual player in the market) should take appropriate steps in educating the general public/creating public awareness about prevention of money laundering activities;

vi. Anti- money laundering legislation should be constantly reviewed in order to make it up to date with developments in the financial system; and

vii. Ensure that Zambia attains full compliance with international standards.

3.11 PAYMENTS SYSTEMS

188. Financial sector development presupposes, in part, a well functioning, efficient and reliable clearing and payments system. The payments system provides an essential conduit for the circular flow of money and execution of monetary policy. In addition, properly designed payments systems can contribute to financial system stability and promote access to banking and financial services. Over the years Zambia's National Payments System has had several weaknesses that contributed to undermining the development of the Zambian financial markets.

189. In the case of the cheque clearing system, for instance, the use of cheques was declining for a number of reasons including: high frequency of cheques issued against insufficient funds; delays in clearing funds on cheques; and poor and slow processing/operational systems in banks. The implication on cheques processing was that bank customers were at the mercy of their bankers and those that paid by cheque. This situation also created huge amounts of float as a result of funds being tied up in the clearing process.

3.11.1 Constraints and Issues

i. *Cash is the main means of making payments*. Accessibility to financial services for the majority of the population is limited and the payments culture in Zambia generally supports cash transactions;
ii. *Legal framework*. The current payment system is built on weak legal underpinnings. Currently, there is no law in Zambia that governs the payment system *per se;*
iii. *Weak risk management systems in payments, clearing and settlement systems;* and
iv. Reform and modernisation efforts of the payment systems overly concentrated on banking participants

3.11.2 Progress Made to Date

190. In an effort to reform and enhance the efficiency of the payments system, the BoZ initiated a study of payment systems within the region in 1993 and by 1995 was working together with the Bankers' Association of Zambia on reforming the Zambian payment systems. The objective of the reform has been to formalise an efficient payments, clearing and settlement system for the Zambian financial system within a clear legal framework. The following are some of the measures that have been implemented to make the National Payments System more efficient and reliable:

i. *Establishment of electronic clearing.* BOZ in conjunction with the Bankers Association of Zambia introduced an automated electronic clearing system, called Zambia Electronic Clearing House (ZECH), in 1999;
ii. *Zambia Clearing House rules were redrafted*: These set clear entry criteria, management of the clearing house, failure to settle arrangements and reduction in clearing periods;
iii. *Improvement of the security of cheque paper and introduction of machine-readable cheques:* This enhanced the security features of cheques and improved the speed of processing and turn-around time for cheques;
iv. *Cutting down on the number of days to clear cheques:* The number of days for clearing a cross-country cheque was cut down from 21 to 10 days. The inter-provincial, along the line of rail, and local clearing days were reduced to 6, 4 and 3 days, respectively;

v. *Improvements in the banks' internal processing procedures:* Most banks have deployed systems that enable the updating of customers accounts from central points;

vi. *Introduction of direct debit and credit clearing (DDACC) for payment of bills and salaries.* DDACC was introduced to facilitate transfer of money by electronic means;

vii. *Large value clearing system (real-time gross settlement system).* Work on this system has advanced and is expected to be operational in mid 2004. Real time settlement also provides a speedy and safe alternative for high-value payments;

viii. *Legal framework.* Research on the legislation in Zambia revealed that the law did not support a number of best practices. Therefore, the BoZ made recommendations to the Minister of Finance and National Planning on introducing legislation, which among other things, will provide a legal framework for electronic and other forms of payment instruments.

3.11.3 Recommendations

3.11.3.1 Payment Instruments and Infrastructure

i. *Encourage payment system participants to develop a variety of payment instruments with emphasis on credit-push instruments:* The decision makers responsible for developing payment instruments will be encouraged to develop and deploy instruments that can be accessible by a majority of customers, especially the rural unbanked and those who get wages and salaries by cash;

ii. *Promote the use of Electronic Payments*: The banking sector and the Zambia Electronic Clearing House Limited will work out and implement measures that will ensure that bank customers and non-bank customers utilise Direct Debits and Credits Clearing to make and receive payments;

iii. *Promote accessibility of the payment system to non-bank participants.* The BoZ will guard against access restrictions in various co-operative arrangements in payment systems. All payment system arrangements should clearly spell out mechanisms for guaranteeing access to participants, particularly non-bank participants;

iv. *Develop and Share of small values payment infrastructure:* Currently, the few banks with ATMs and POS Terminals operate on an individual basis. Measures will be developed and implemented that will ensure sharing of these facilities by payment system participants, including non-bank participants. This may be in the form of joint acquisition and implementation of a switching centre, or a private operator can offer this;

v. *Introduce cheque truncation and code line clearing*: The National Payment System should develop and implement measures to introduce cheque truncation using the imaging system at the ZECHL and other non-bank participants. At the same time, measures will be taken to ensure that appropriate technology and communication systems are used to electronically process all payment transactions countrywide;

vi. *Develop centralised banking system by payment system participants.* The National Payment System will encourage participants to upgrade their operational systems to enable both Straight-Through-Processing and centralised book-keeping of customer's accounts to improve efficiency and customer service delivery.

3.11.3.2 Efficient Payment Practices and Public Awareness

i. *Educate the public on payment system issues:* The enforcement of agreed rules, regulations and code of conduct as well as the use of various payment instruments will only be effective if service providers and customers are aware of them. The BoZ will formulate and implement public education programs so that the public is made aware of the developments in payment systems. All payment system participants will develop programs to educate their customers on risks involved with the payment instruments that customers will use and the alternatives to various payment instruments offered; and

ii. *Introduce regulatory framework for providers of payment services:* Legally enforceable rules, regulations, agreements and codes of conduct need be formulated for each payment stream. These will be published for the information of all interested parties in order to ensure sound and open practices.

3.11.3.3 Sound Legal Framework

191. The MoFNP should expedite and finalise the enactment process of the proposed Payments Systems Act. It is envisaged that promulgation of this proposal into law, currently with the Ministry of Finance and National Planning, will contribute to building public confidence in non-cash means of effecting payments

3.11.3.4 Risk Management

i. Introduce online BoZ settlement system to enable banks to effect high value funds transfer electronically in real time.
ii. Link ZECHL, LuSE, Commercial Banks and BOZ trading systems to the BOZ settlement system.
iii. Introduce continuous processing at the ZECHL to enable participants to effectively monitor and manage their exposures.
iv. Introduce mechanisms to give banks access to their settlement account at BoZ to enable them manage their settlement accounts.
v. Introduce final and irrevocable same day settlement.
vi. Develop and implement risk management measures and monitoring tools.

3.11.3.5 Effective Management of the National Payment System Structures

i. *Reconstitute a broad-based National Payment System Committee:* The National Payment System extends beyond the banking system. Therefore, the National Payment Systems Committee will be reconstituted as the policy making body on all payment system issues. It will be composed of representatives from various interests in the payment system. It will also approve proposals and recommendations from the Working Groups and provide resources to the Working Groups to carry out their delegated functions.
ii. *Form a Payment Systems (Core) Specialised Team:* This team will be a joint cooperation among payment system participants to spearhead the reforms. It will be adequately trained in payment system issues as part of capacity building for both BOZ and relevant participants.
iii. *Establish Payment Systems Working Parties*: Various Working groups will be formed to look at various components of the National Payment System on a need basis. These will have representation from the Specialised Team and technical representation from other interested parties relevant to the component being addressed. This will be the second structure under the National Payment Systems Committee.

3.11.3.6 Repositioning the National Payment System.

192. Despite recent improvements, the payments system still needs further refinements to consolidate the achievements so far attained and safeguard it against settlement failure. Some of the required improvements include:

i. Enhancements to the infrastructure to effectively serve the rural population;

ii. Achievement of Delivery versus Payment on the Lusaka Stock Exchange;

iii. Regional integration and facilitation of cross-boarder payments;

iv. Development of other more accessible and acceptable payment instruments such as shared ATMs, POS and Electronic Funds Transfer systems to reduce reliance on cash;

3.12 FINANCIAL SECTOR TAXATION

193. As a general principle, it is important that taxation of the financial sector is as consistent as possible with the basic tax design objectives of equity, efficiency and simplicity in order to minimise distortion and promote competitiveness and development of the financial sector.

194. The financial sector attracts particular interest from a taxation point of view because of three key attributes, namely:

i. The wide array of transactions capable of being carried out in the sector, which make measurement of income and value-added complicated;

ii. The element of time in the income stream of financial institutions. Unlike other sectors, financial institutions deal in products and services that are provided over extended periods of time, and involve varying degrees of risk and profitability; and

iii. The high vulnerability of the sector to market failure and other externalities, which more than often compels authorities to institute tax or non-tax corrective action.

3.12.1 Income Taxes on the Financial Sector in Zambia

195. In Zambia for all banks that are registered under the Banking and Financial Services Act for profits of up to the first K250 million they pay a standard corporate tax rate of 35 percent with the balance taxed at 45 percent.

196. A final withholding tax rate of 25 percent is withheld on interest earnings of individual financial institution clients. For other institutions including the financial institutions themselves a 15 percent withholding tax is levied and it is not a final tax. For commissions, dividends, royalties, management and consultancy fees is levied at 15 percent. In addition, to the withholding tax a medical levy of 1 percent is taxed on all interest earnings.

3.12.2 Objectives of Taxation

197. As a general principle, taxation of the financial sector should aim at achieving three objectives, namely:

i. *Equity:* The system should define appropriate measurement of ability to pay to guide the assessment of tax liability;
ii. *Efficiency:* the system should minimise the distortion imposed on the financial sector for any amount of revenue collected; and
iii. *Simplicity:* the system should impose minimal administrative burden to foster compliance.

3.12.3 Constraints and Issues

198. Taxation of the financial sector is invariably a complex undertaking, which brings out a lot of issues. Policy decisions on taxing the financial sector in a country like Zambia have to contend with constraints such as:

i. *Fiscal constraints:* The Government has to contend with a very constrained domestic revenue base. Financial sector taxation reform has to be carried out in a manner that protects the revenue base;
ii. *Efficacy of Tax Relief:* Ordinarily, it is appealing to introduce tax relief to "encourage" objectives such as stock exchange listing or household savings, but these schemes often entail high revenue loss in relation to supposed benefits;
iii. *Impact of Corrective Action:* Corrective taxation measures are not regularly evaluated and adapted through closer liaison between monetary, fiscal authorities and stakeholders.

iv. *Inadequate coverage of the formal financial sector:* The existence of an informal financial sector may create unfair disadvantage to players in the formal financial sector who have to comply with regulatory and tax obligations;

v. *The menu of financial assets:* available may be too narrow to permit a wide variety of financial transactions, thus limiting the number of tax handles available within the financial sector;

vi. High taxes imposed on the financial sector are partly as a result of weak institutional framework in the tax collection system.

vii. The tax system on the financial sector has increased the cost of financial services to the local enterprises which has made them not to be competitive in the region.

3.12.4 Progress Made to Date

199. There has been marked progress, and, at the least, explicit commitment of the authorities towards addressing the issues facing financial sector taxation.

i. Inadequate coverage of the formal financial sector is being addressed by encouraging financial institutions to mobilise savings, thus bringing more individuals into the formal financial sector;

ii. The limited menu of financial assets is being addressed by deepening the financial sector and encouraging financial institutions to devise innovative financial products;

iii. Government is making a sustained effort in addressing the present fiscal constraints by implementing fiscal and budget reforms; and

iv. Steps have been taken to reverse extension of tax incentives aimed at achieving objectives that cannot be quantified in specific revenue or tangible economic benefits.

3.12.5 Recommendations

200. In order for taxation of the financial sector to achieve its objectives of equity, efficiency and simplicity, it is important that the coverage of the formal financial sector is as broad as possible and that the bulk of transactions in the economy are conducted through the formal financial sector. Some key issues that need to be addressed to achieve this that could be considered are that:

i. There must be sustained policy commitment and action by the monetary authorities to address the existence of the informal financial sector through reduction of transaction costs and barriers to participation in the formal financial sector;

ii. Financial intermediaries should be encouraged to develop innovative financial products that will encourage participation in the formal financial sector;

iii. The efficacy of tax relief on the financial sector should be subjected to more vigorous cost-benefit analysis.

iv. The payments system in the country should be encouraged to develop faster and more convenient non-cash transaction mechanisms to reduce reliance on cash transactions

v. There should be closer liaison between the monetary and fiscal authorities on taxation of the financial sector to ensure that the effects of explicit and implicit taxation are fully associated

vi. Government determination of taxation levels on services in financial sector should be such as to promote regional competitiveness of the local enterprises.

vii. Government should apply uniform structure on taxation across all sectors including the financial sector.

viii. Government and the Zambia Revenue Authority should consider whether the financial sector taxation be approached from an institutional or a financial product perspective.

ix. Government should encourage pension funds and life assurance funds investments in long term capital projects by extending preferential income tax treatment on income earned from such investments.

CHAPTER 3

Key Financial Sectors Issues

4 THE REGULATORY AUTHORITIES

4.1 INTRODUCTION

201. There are three institutions that regulate the financial sector in Zambia. These are the BoZ, the Securities and Exchange Commission (SEC) and the PIA.

202. The BoZ was established in 1964 as the central bank of Zambia. It is charged with the responsibility of formulating and executing monetary and supervisory policies, with the ultimate objective of achieving price and financial systems stability. Apart from serving as a banker, fiscal agent and adviser to the Government, the BoZ is also a banker for all commercial banks. The BoZ currently derives its mandate from the BoZ Act of 1996 and the Banking and Financial Services Act, 1994 as amended.

203. The SEC was established by the Securities Act, 1993. Its constitutive Act charges it with the responsibility of, among other functions, regulating, supervising and developing the securities industry in Zambia.

204. The office of the Registrar of Pensions and Insurance (generally known as the PIA) was established in 1997 with the mandate of enforcing two pieces of legislation, namely, the Pension Scheme Regulation Act No. 28 of 1996 and the Insurance Act no 27 of 1998 (formerly Chapter 392 of the laws of Zambia). The office is a semi-autonomous entity without distinct legal personality under the Ministry of Finance and National Planning.

205. The BoZ, SEC and PIA strive to attain world-class standards of regulation and supervision. However, in their efforts to attain their vision the regulatory authorities face some constraints as set out below.

4.2 CONSTRAINTS AND ISSUES

4.2.1 The Bank of Zambia

4.2.1.1 The Governance Structure and Potential Conflict of Interest

206. The Chief Executive Officer of the BoZ is the Governor. By powers given in the BoZ Act, the Governor is also the Chairman of the BoZ Board of Directors. The Governor and two Deputy Governors constitute the executive of the BoZ. The three officers are appointed by the Republican President for periods of not more than five years.

The President also has the power to re-appoint them to office upon expiry of their term of office.

207. The Board of Directors of the BoZ is responsible for the formulation of policy and constitutes the Governor and no more than six other persons appointed by the Minister of Finance and National Planning. The Secretary to the Treasury in the Ministry of Finance and National Planning, who is an ex-officio member of the Board with no voting powers, represents the Government.

208. Under the current legal framework, the independence of the BoZ in executing its duties may be compromised. Section 5 of the BoZ Act provides that *"5.The Minister may convey to the Governor such general or particular Government policies as may affect the conduct of the affairs of the Bank and the Bank shall implement or give effect to such policies.*" The mandatory tenor in which this provision is couched leaves little doubt of the overriding influence that the minister may wield over the BoZ on some policy matters.

4.2.2 Securities and Exchange Commission

209. Similarly, the SEC is faced with constraints arising from its governing legislation, from where the possibility of conflict of interest is also present. The Securities Act provides that the LuSE shall be one of the seven prescribed institutions that are entitled to be represented on the Board of Commissioners. The Commission regulates and supervises the LuSE.

210. Under this structure, the possibility of a conflict of interest is apparent in having a regulated institution sitting on the Board of its regulator. This undermines the objectivity of the Board especially in matters such as the supervision, regulation and disciplining of the LuSE by the Commission.

211. There is a serious under-funding of the Commission with the result that it cannot fully meet its statutory function of supervision and oversight alongside its other mandate of developing the securities market. For example, the Commission cannot engage in any well coordinated awareness campaigns for the development and sustenance of the sub sector, neither can it implement its approved staff establishment.

4.2.3 Pensions and Insurance Authority

212. The PIA is not set up as statutory body corporate and, as a result, it has no distinct legal personality and no governing board. The Registrar reports to the Minister of Finance and National Planning through the Secretary to the Treasury.

213. As a consequence there has been slow progress made in attending to issues such as improving conditions of service for staff with a view to retain qualified and competent personnel.

214. The office has not been adequately funded to meet its operational needs, which include training and consumer education. The office is wholly dependent on monthly grants from the Government.

4.3 PROGRESS TO DATE

215. Submissions are being collected on reviewing the BoZ and Banking and Financial Services Acts. A committee on law reform has been constituted within the BoZ.

216. As a means of raising awareness, the SEC has conducted workshops with secondary school teachers about the basics of capital market operations and the instruments commonly used, following a successful incorporation of these into the syllabi of commercial subjects at secondary school level.

217. Proposed amendments to the Pensions and Insurance Act, which include the establishment of the office as a statutory body, have been made to the government.

218. The PIA has formulated a training policy, which is aimed at enhancing its human resources capacity.

4.4 RECOMMENDATIONS

4.4.1 Bank Of Zambia

i. The Governor should be appointed by the President on the recommendation of an independent body subject to ratification by Parliament.
ii. The Governor should be removed only with the concurrence of an appropriate independent body.

iii. The tenure of the Governor's term of office must not run concurrently with the term of office of a particular Government. This will guarantee the Governor's continuity in office, enhance professionalism and diminish the latitude for patronage.
iv. The Board of Directors should comprise members from key financial and economic associations and stakeholders in the economy. The directors should be Zambian nationals with recognised and appropriate qualifications and experience in economic and financial affairs.
v. There is need to amend the BoZ Act and any other relevant law to enhance and protect the independence of BoZ in carrying out its central bank functions.

4.4.2 The Securities and Exchange Commission

i. The Securities Amendment Bill must speedily be enacted into law.
ii. The capacity of the SEC must immediately be boosted by establishing viable funding arrangements, including the raising of supervisory fees to enable it to discharge its statutory mandate.

4.4.3 The Pensions and Insurance Authority

i. The PIA must be established as an autonomous supervisory authority;
ii. Bringing National Pensions and Savings Authority (NAPSA) under some independent supervisory authority and implementing the investment allocation guidelines for Contractual Savings Providers;
iii. Review the funding policy of the PIA. Consideration could be given to the imposition of a levy on pension fund contributions and insurance premiums to sustain the operations of the PIA;
iv. Amendments to the Pension Scheme Regulation Act need to be expedited to strengthen the supervisory capacity; and
v. Consideration must be given as to how NAPSA could be subjected to supervision

5 BANKING SECTOR

5.1 INTRODUCTION

219. Commercial banks – mostly subsidiaries of foreign banks - are the most dominant and oldest financial institutions in Zambia. Their dominance is reflected in the size of their total assets relative to other types of financial institutions as well as in their relatively wider role in financial intermediation. Commercial banks also have a wider outreach than any other financial institution and as at 2002, had a total branch network of 140.

220. Traditionally, the commercial banks are engaged in provision of short-term finance whilst specialised banks and other non-bank financial institutions provide long-term finance. Commercial banks offer traditional retail banking services, including current, savings and term deposit facilities, short-term and medium lending facilities, trade finance, money market trading activities, foreign exchange trading activities, safe deposit facilities and other banking facilities.

221. As at 30th June 2003, there were a total of 14 commercial banks operating in Zambia. Of these, six were private foreign owned banks, whilst two were foreign state owned banks[1]. One bank was state owned and local entrepreneurs owned the rest. The table below gives a listing of all commercial banks, their respective market shares including branch networks.

5.1.1 Market Share: Assets, Loans and deposits

222. Subsidiaries of foreign banks[2] continue to take the lead in controlling banking system assets, loans and deposits. As at 30th June 2003 they controlled 65% of the banking systems' total assets, 85% of total loans and 64% of total deposits compared to 64%, 82% and 66%, respectively in December 2002. Government-owned banks[3] on the other hand accounted for 26% of the industry's total assets, 7% of total loans and 28% of total deposits compared to 26%, 10% and 28%, respectively in 2002. Local banks[4] continued to lag behind and accounted for 9% of the industry's total assets, 8% of total loans and total deposits compared to the previous year's 9%, 8% and 6% in December 2002. Table 5.1

[1] *Of the foreign state owned banks, one was a joint venture between the Governments of India and Zambia and the other by the Government of China*
[2] *These are locally incorporated subsidiaries of foreign banks*
[3] *Banks, which are wholly or partially owned by the Government of the Republic of Zambia (Two of them).*
[4] *Other banks incorporated locally which are not subsidiaries of foreign banks or Government owned.*

223. below illustrates the distribution of the banking sector total assets, loans and deposits by type of ownership.

5.1.2 Size of the Banking Industry

Table 5.1: Total Assets, Capitalisation and Profitability of Commercial Banks (K' million)

	Total Assets (TA)	Share of TA	Total Capital	Profit before tax	Capitalisation	ROA	ROE	Branches[5]
	K' million	%			%	%	%	
BBZ	1,017,991	21.8	107,308	80,655	10.5	7.9	64.4	27
ZNCB	931,475	19.9	59,372	15,230	6.4	1.8	23.2	43
SCB	787,330	16.8	92,222	61,765	11.7	9.0	68.1	15
STAN	544,837	11.7	53,784	43,504	9.9	8.7	95.4	8
CITI	487,878	10.4	109,728	43,080	22.5	10.0	47.1	2
INDO	272,082	5.8	47,678	16,008	17.5	7.1	39.9	7
FBZ	284,162	6.1	31,013	18,011	10.9	6.4	52.1	32
BOC	62,992	1.3	5,801	109	9.2	0.2	1.9	1
FAB	65,621	1.4	21,543	10,520	32.8	17.3	52.3	3
ABC	101,386	2.2	12,188	4,987	12.0	59.7	498.7	1
INVEST	45,865	1.0	7,292	1,253	15.9	3.2	14.7	2
CAV	26,830	0.6	5,055	2,784	18.8	12.9	36.2	1
IDH	26,645	0.6	7,927	3,553	29.8	13.2	50.5	1
N/CAP	21,217	0.5	4,959	1,151	23.4	6.0	22.8	8
	4,676,311		**565,870**	**302,610**				**140**

KEY

BBZ=Barclays Bank Zambia Plc; ZNCB= Zambia National Commercial Bank Ltd; SCB= Standard Chartered Bank Zambia Ltd; STAN=Stanbic Bank Ltd; CITI= Citibank Zambia Ltd; INDO= Indo Zambia Bank Ltd; FBZ=Finance Bank Zambia Ltd; BOC= Bank of China; FAB=First Alliance Bank Ltd; ABC=African Banking Corporation; INVEST=Investrust Bank Ltd; CAV=Cavmont Merchant Bank Ltd; IDH=Intermarket Discount House Ltd; N/CAP=New Capital Bank PLC.

5.1.3 Market share: Profit before Taxation

224. For the first half of 2003, the distribution of profit before taxation by type of ownership indicated that foreign owned banks accounted for 73% of the industry's total

[5] The number of branches is as at December 2002.

earnings, whilst government banks accounted for 12% and the local banks accounted for 15%, compared to 68%, 22% and 10% respectively in December 2002. Table 5.2 below shows the distribution of profit before tax by type of ownership.

Table 5.2: Distribution of the banking sector's assets, loans and deposits by type of ownership 2001- June 2003 (K' billion)

	June 2003						**Dec 2002**						**Dec 2001**					
	Assets	%	Loans	%	Deposits	%	Assets	%	Loans	%	Deposits	%	Assets	%	Loans	%	Deposits	%
Foreign Banks	3,274	65	925	85	2,274	64	3,029	64	798	82	2,142	66	2,284	66	783	73	1,546	64
Government Banks	1,321	26	75	7	1,005	28	1,251	26	94	10	913	28	857	25	251	23	673	28
Local Banks	449	9	86	8	254	8	444	9	83	8	202	6	319	9	45	4	187	8
Total	5,044	100	1,086	100	3,533	100	4,724	99	975	100	3,257	100	3,460	100	1,079	100	2,406	100

Table 5.3: Analysis of the banking sector's earnings by type of ownership

(K' million)

	June 2003		**Dec 2002**		**Dec 2001**	
	Profit before tax	%	Profit before tax	%	Profit before tax	%
Subsidiaries of foreign banks	99,158	73	237,653	68	184,516	125
Government banks	16,550	12	78,926	22	(54,963)	(37)
Local banks	19,725	15	33,719	10	18,963	12
Total	135,433	100	350,298	100	147,907	100

5.1.4 Legal and Regulatory Framework

225. The legal framework for the banking sector primarily consists of the Companies Act, the BoZ Act and the BFSA. Further, banks, which operate as public companies, are required to comply with the provisions of the Securities Act.

226. The regulatory framework of the banking industry consists of the BoZ as the regulatory agency for both the banking and non-banking financial institutions sectors. The

BoZ's power to regulate banks is derived from the BoZ Act and the BFSA. The BFSA gives the BoZ power to supervise banks and non-bank financial institutions. It also gives the BoZ power to prescribe, issue regulations and guidelines and to enforce them. The power to licence banks lies with the Registrar of Banks and Financial Institutions.

227. An assessment of BoZ's supervisory practices against best practice[6] revealed that the framework for banking supervision was generally adequate and that supervisory skills were of a good standard. Further, most prudential guidelines including those for capital adequacy, single and related party exposures, and net open foreign currency exposure are in line with the Basel requirements.

5.2 CONSTRAINTS AND ISSUES

5.2.1 Financial Intermediation

228. Financial intermediation in Zambia is low. Zambian banks are holding a larger proportion of their assets in government securities and foreign assets than other Sub-Saharan African countries. Zambian banks hold a significant part of their foreign currency deposits outside the country. This reduces the resources available for lending in Zambia. Further, Zambia has one of the highest ratios of public sector credit to total commercial bank assets on the continent.

229. The ratio of private sector credit to GDP in Zambia at 8% is one of the lowest ratios in Sub- Saharan Africa. The ever-increasing demand for credit to the government has pushed real lending rates very high and only major corporations can borrow at the prime rate. The high real interest rates not only discourage potential borrowers, but also make the banks wary of credit risk, since mainly undesirably risky businesses attempt to borrow at high real rates. Almost all lending is short-term, partially as a measure to control credit risk and partially because sources of finance (deposits) are largely of a short-term nature.

[6] The 25 Core Principles for Banking Supervision provide best practise against which the effectiveness of Bank Supervision practices are assessed worldwide. To date Zambia has carried out three self-assessments and one external assessment by the FSAP team.

5.2.2 Structure of earnings

230. Earnings of the Zambian banks are mostly dependent on foreign exchange trading and interest on Government securities. This reduces the incentives to expand intermediation for the private sector. Without income on foreign currency operations, most banks would have been unprofitable over the last four years.

5.2.3 Financial Stability

231. Over the last twelve years, the Zambian financial system has experienced episodes of bank failures, which have had several adverse effects on the confidence in the financial system.

5.2.4 Credit Culture

232. Zambia has a weak credit culture. It is possible for borrowers to default on loans without affecting their credit ratings with other financial institutions. This discourages borrowers from repaying their outstanding loans in both failed and operating banks.

233. Related to the above, there is a tendency among borrowers to have their assets (used as collateral) overvalued in relation to the amounts of the loans they obtain. This encourages borrowers to default on loan repayments.

5.2.5 Cost of Banking Services

234. Zambian banks have extremely high operating costs. This cost structure makes it difficult to develop efficient low-cost services that the population can afford.

5.2.6 Regulatory and Legal Infrastructure

235. The treatment of erring directors of failed and operating financial institutions by some regulatory authorities has been lenient, with appropriate action not taken in some cases of blatant violation of laws. In some cases, managers were/are even allowed to take jobs elsewhere in the financial sector.

236. There is a widespread perception that financial crimes are not prosecuted, whether it is mismanagement and political lending in the public financial institutions, staff embezzlement, client fraud, willful default on loans, or mismanagement in banks that lead to failure and loss of depositors' funds, or corruption, or money laundering. This adversely affects the development of the financial sector by reducing public confidence.

237. Notwithstanding the adequacy of the supervisory practices, the following deficiencies are noted:

i. Enforcement of the banking laws is weak and the general recovery process through the legal mechanism is slow;
ii. Interference in the execution of the supervisory function due to lack of central bank independence;
iii. Minimum capital requirement has been eroded in real terms by inflation since it was last adjusted in 1996. The minimum capital requirement in real terms is one of the lowest in Africa; and
iv. The BoZ's internal procedures for liquidating banks are cumbersome and lengthy;

5.2.7 Banks in liquidation

238. The BoZ has not had adequate mechanisms for the management of banks in liquidation and the activities of liquidation managers. This has allowed failed banks to languish without resolution and liquidations to drag on for years thereby sending perverse signals to the market. Because of the growing tradition of lacklustre post-failure collection efforts, borrowers have incentives to push troubled banks toward failures by withholding repayment.

5.3 Other Constraints recognised

i. The banking sector is dominated by foreign banks.
ii. Lack of infrastructure in rural areas, leading many commercial banks to withdraw or close branches in these areas.
iii. Banks are not contributing towards community development in the communities they operate in.
iv. High and interest free statutory reserve requirement contribute to high banking costs.
v. Banks are not financing Micro-enterprise and Small and Medium enterprise (SME) sector, which is the engine of economic growth.

vi. Due to the difficulty by the public to compare bank charges, customers are subject to exorbitant bank charges.

5.4 PROGRESS MADE TO DATE

5.4.1 Financial Stability

i. The BoZ has introduced a Macro-Prudential Supervision framework to enhance it's capacity to anticipate financial instability;
ii. Capacity building in Risk Management and Anti-money laundering activities has been initiated through institutions like the Zambia Institute of Bankers, The BoZ and other private sector providers of education;
iii. The BoZ in conjunction with the East and Southern African (ESAF) group of bank supervisors has implemented Bank Supervision Application, an IT based system to enhance it's Early Warning System, on-site and off-site supervisory capacity. This will ultimately enhance the Bank 's monitoring capacity and strengthen financial stability; and
iv. The BoZ has initiated steps to ensure that each individual bank establishes risk management systems in its daily operations.

5.4.2 Credit Culture

239. Steps to establish a credit reference bureau are underway. It is expected that the Credit Bureau once established will be supervised by the BoZ.

5.4.3 Financial Stability

240. Corporate Governance guidelines for the banking industry have not yet been issued.

5.4.4 Banks in Liquidation

241. The procedures for the takeover of banks at the time when a bank goes into financial distress have not been revised.

242. Modalities for the preservation of information on bank managers' activities when the bank was operational have not yet been reviewed.

5.4.5 Credit Culture

i. The establishment of a separate tribunal for handling cases of loan default has not commenced.
ii. Review of secrecy laws has not commenced.
iii. Review of the Statutory Instrument on practitioners' fees is still to be considered.
iv. The review of liquidation procedures to include bankruptcy proceedings has not commenced.
v. The issuance of guidelines for valuation of properties pledged as collateral for bank credit has not been done.

5.5 RECOMMENDATIONS

5.5.1 Financial Stability

i. Raise the minimum capital requirement to Kwacha equivalent of US$1.5 million consistent with the Common Market for East and Southern Africa (COMESA) standard;
ii. Establishing a credit reference bureau and a Deposit Protection Scheme for banks and deposit-taking financial institutions to help enhance credit culture and instil confidence in the financial system;
iii. Enhance supervisory capacity;
iv. The BoZ's intervention in the industry should be rule-based and legislated. This will enable the bank to take prompt corrective action and reduce the effects of regulatory forbearance. Making supervisory responses mandatory limits supervisory discretion and offsets the pressure on bank supervisors to delay prompt corrective action;
v. The early warning system should be enhanced to include trigger ratios, which will require specified actions to be taken when a trigger point is reached. In their current format, they do not prescribe what action needs to be taken when a particular threshold is reached;
vi. The BoZ should prescribe corporate governance guidelines for the banking sector;
vii. Introduce macro-prudential supervision in order to enhance monitoring of the various external and internal indicators that have a significant bearing on the stability of the banking sector; and

viii. Prescribe more business functions in which banks will be required to maintain risk management systems.

5.5.2 Banks in liquidation

243. Review and enhance the liquidation guidelines especially in relation to enforcement of guarantees and instituting bankruptcy measures.

5.5.3 Credit Culture

i. Establish a credit reference bureau;
ii. Enact a law dealing with bank-customer confidentiality;
iii. Enhance the capacity of the commercial courts and encourage the use of Alternative Dispute Resolution mechanisms;
iv. The BoZ, like is the case with auditors, should approve all valuation surveyors engaged for the purpose of valuing collateral for loans. Further the BoZ should issue guidelines for the valuation of such properties to the registered surveyors; and
v. Harmonise the administration of the Insolvency, Bankruptcy and Banking laws.

5.5.4 Legal Infrastructure

244. The BoZ should make a formal arrangement that will facilitate periodic review of all banking laws in order to address developments in the industry.

5.5.5 Cost of Banking Services

i. Promote the development of second tier commercial banking services to enhance competition in the banking sector;
ii. Consumers need to be educated to adjust banking practices or switch banks to find lower fees, which would encourage competition among the banks; and
iii. Find out ways and means of providing banking services at affordable costs to the general public.

5.5.6 Other Recommendations

i. To promote local participation in the commercial banking sector, banks should be encouraged to list on the Lusaka Stock Exchange;

ii. A study should be undertaken to find alternative ways of delivering banking services to the rural areas;
iii. Banks should be compelled to submit their charges to BoZ who in turn should publish the same in media as a comparative chart so that all consumers are aware of bank charges across the industry; and
iv. In order to help reduce cost of banking services, the BoZ should review and set the statutory reserve ratio consistently with the macro-economic conditions.

6 NON-BANK FINANCIAL INSTITUTIONS

6.1 INTRODUCTION

245. Traditionally, non-bank financial institutions (NBFIs) include all financial institutions that are not classified as commercial banks. These include specialist lenders, contractual savings institutions and bureaux de change. The Banking and Financial Services Act (BFSA) of 1994 recognises specialist lenders such as leasing companies, building societies and micro finance institutions. It excludes the contractual savings institutions such as venture capital funds, brokers/dealers, as well as pensions and insurance companies, and collective investment schemes in the definition. However, for purposes of this chapter, the non-bank financial institutions include the specialist lenders, contractual savings institutions and bureaux de change. The venture capital funds, stock brokers/dealers and collective investment schemes are discussed in Chapter 7 under financial markets.

246. NBFIs complement the role of commercial banks by providing some financial services that commercial banks may not be well placed to provide. They also compete with commercial banks and challenge them to be more efficient and responsive to the needs of their customers. The NBFIs represent the linchpin for financial sector transformation in Zambia. NBFIs also target the under-served customers namely, rural consumers and small businesses ignored by the traditional banking channels.

6.2 SPECIALIST LENDERS AND BUREAUX DE CHANGE

247. NBFIs supervised under the BFSA include specialist lenders and bureaux de change. Specialist lenders comprise development finance institutions, savings and credit banks, agricultural and housing finance institutions, which are mostly Government-owned and micro finance institutions. Since the liberalisation of Zambia's financial sector in the early 1990s, the number of specialist lenders has increased, mainly because of private sector investment in leasing companies and building societies. Some of the specialist lenders raise funds from the public, in form of deposits and deposit-like instruments, and/or from the domestic banks and other NBFIs. Consequently, they are liable to be supervised by the BoZ.

248. The objectives of the FSDP for the specialist lenders and bureaux de change include:

i. Broadening the range of financial services provided by NBFIs;
ii. Provision of medium to long-term credit;
iii. Extending financial services to rural and peri-urban areas; and
iv. Achieving adequate regulation of the NBFIs sector.

249. NBFIs falling under the supervisory ambit of the BoZ can be categorized into four distinct types of institution:

i. *Leasing companies*: The leasing companies are commercial ventures that are established under the Companies Act. Their main activity is provision of finance leases and short-term loans. They finance their operations through equity, foreign lines of credit such as the Enterprise Development Fund (EDF) of the World Bank. In addition, leasing companies mobilise funds from the public through money-market instruments or "debentures".

   Leasing companies have been under the BoZ supervision since early 1990s. As at 31 December 2003 there were 7 operating leasing and finance companies with total assets amounting to K225 billion, representing 1% of GDP and 4% of banking sector total assets;

ii. *Development Finance Institutions (DFIs)*: DFIs in Zambia have been established and funded by the Government in collaboration with bilateral and multilateral institutions to provide medium to long-term finance. These institutions are established under separate statutes and largely do not take deposits. Currently, there is only one DFI, the DBZ, following the closure of other DFIs (Lima Bank, Export and Import Bank and Cooperative Bank) in the mid 1990s. DBZ provides medium to long-term development finance.

   DFIs were brought under BoZ supervision after the amendment to the BFSA in 2000. As at 31st December 2003, DBZ's total assets were K28 billion representing 0.14% of GDP and 0.51% of banking sector total assets;

iii. *Housing Finance Institutions*: Housing finance institutions (HFIs) traditionally provide mortgage finance. In Zambia, they have tended to take two major forms namely building societies and employer-sponsored housing loan schemes. Over the years, increases in interest rates and the decrease in disposable incomes have combined to increasingly make it difficult for ordinary people to afford mortgages. Consequently, the role played by in-house housing loan schemes offering below market interest rates has been on the increase. Building societies are governed by the Building Societies Act 1968. They take deposits from their members. As at 31st December 2003, there were three building societies with total assets of about K47 billion representing 0.23% of GDP and 0.86% of banking sector total assets;

iv. *Rural banking and micro finance institutions*: These are institutions that deal directly with the public, take deposits and make loans to individuals. These institutions were established under various pieces of legislation, such as the NSCB Act, Cooperatives Act and Societies Act. These include the NSCB and MFIs estimated to be between 40 and 50, which use donor funds to make loans to individuals and small enterprises. The NSCB and MFIs were brought under the BoZ supervision following the amendments to the BFSA in the year 2000. As at 31 December 2003 total assets of NSCB and two MFIs licensed by BoZ amounted to K55 billion representing 0.27% of GDP and 1.0% of banking sector total assets; and

v. *Bureaux de Change*: These are foreign exchange shops that buy and sell foreign exchange in small quantities and do not take deposits. Since 1994, bureaux de change were operating under Statutory Instrument (SI) No. 44 of 1994 issued under the BoZ Act No. 21 of 1994. From April 2003, bureaux de change have been operating under SI number 38 issued under the BFSA. As at 31 December 2003, there were 29 bureaux de change with total assets of K6 billion representing 0.03% of GDP and 0.11% of banking sector total assets.

6.2.1 Constraints and Issues

6.2.1.1 General Constraints

i. Low capitalisation in HFIs & DFIs, rural banks and MFIs;
ii. DBZ Act, NSCB Act, BS Act are in conflict with BFSA;

iii. Limited supervisory powers of BoZ over HFIs, DFI, MFIs and rural banking institutions;
iv. Inappropriate regulations for leasing and finance companies, DFIs, HFIs, MFIs and rural banking institutions;
v. Lack of long-term and appropriately priced funds;
vi. Lengthy legal process of security realisations;
vii. Poor credit culture;
viii. Inadequate competition;
ix. Inadequate financial product innovation;
x. Limited supervisory powers by BoZ; and
xi. Absence of a deposit protection scheme.

6.2.1.2 Leasing Sector Constraints and Issues

i. The inconsistencies in the tax and regulatory framework adversely affect the existence of the leasing sector. For sustainable leasing prospects, the Government must be committed to a favourable and consistent First Year Allowance in the Income Tax Act. The imposition of Value Added Tax (VAT) on lease finance charges is stifling the growth of the sector.

6.2.1.3 Development Finance Constraints and Issues

i. Weak corporate governance structures
ii. Weak regulatory framework
iii. DFIs have not effectively been playing their role due to inadequate capital

6.2.1.4 Housing Finance Institutions Constraints and Issues

i. Outdated legislation – BSA of 1968 constraining operations;
ii. Lack of secondary market for mortgages; and
iii. Absence of tax relief on interest on mortgage bonds.

6.2.1.5 Rural Banking and Micro Finance Institution Constraints and Issues

i. Collapse of Government-owned financial institutions;
ii. Closure of commercial banks' rural branches;

iii. High minimum balance requirements for savings accounts in almost all banks;
iv. Absence of Government policy on rural banking and MFIs ;
v. Majority MFIs operate in unregulated market and the BoZ has limited supervisory powers for rural banks and MFIs not registered under Companies Act;
vi. High operating costs; and
vii. Limited outreach.

6.2.1.6 Bureaux de change Constraints and Issues

i. Lack of code of conduct;
ii. 25% shareholding limit is inappropriate for bureaux de change;
iii. Foreign exchange over-the-counter transactions limit restricts bureau de change operations;
iv. Vulnerable to abuse by money launderers; and
v. Bureaux de change have limited products as they can only transact in cash and travellers cheques (TCs);

6.2.2 Progress Made to date

i. A Law Review Committee has been constituted to review and harmonise the laws governing financial institutions, through which the DBZ, NSCB and BS Act will be harmonised or repealed to remove regulatory conflicts with the BFSA;
ii. DBZ was restructured under DBZ Act No. 11 of 2001;
iii. Some leasing companies have had access to the World Bank's Enterprise Development Funds; and
iv. Bureaux de change have been brought under the BFSA through the issuance of SI number 38 in April 2003 in line with supervisory requirements for financial institutions.

6.3 RECOMMENDATIONS

i. Taking the final decision and adopting an action plan to address weaknesses of the state-owned non-bank financial institutions, notably the Development Bank of Zambia; the Zambia National Building Society (ZNBS) and the National Savings and Credit Bank (NSCB);

ii. Repealing and/or harmonising the DBZ, NSCB, Building Society Acts to provide for full compliance with the BFSA;

iii. Developing a clear policy and an institutional framework for the provision of financial services in the peri-urban and rural areas;

iv. Issuing Anti-Money Laundering guidelines to enhance the prevention and detection of money laundering;

v. Incorporate HFIs, DFIs, rural banks and MFIs under the Companies Act to minimise regulatory arbitrage;

vi. Develop appropriate regulations for DFIs, HFIs, rural banks; leasing and finance companies;

vii. Review the law relating to VAT on finance lease charges;

viii. Streamline legal process for repossession of leased assets;

ix. Provide capacity building for NBFIs personnel and regulators; and

x. Review the 25% shareholding limit for bureaux

6.4 CONTRACTUAL SAVINGS PROVIDERS

6.4.1 Pensions

250. The pensions sector in Zambia can be categorised into:

i. The statutory pension schemes; and
ii. The occupational private pension schemes.

251. The statutory pension schemes include the Local Authorities Superannuation Fund (LASF), the National Pension Scheme, Workers Compensation Fund and the Public Service Pensions Fund (PSPF). Each of the schemes operates under a separate piece of legislation.

252. The occupational pension schemes currently estimated at over 200, are supplementary schemes sponsored by the private sector employers and employees. There are currently eight Fund Managers.

6.4.1.1 Regulatory Framework

253. The following are the pieces of legislation that have a material bearing on the pension industry in Zambia:

i. The Pension Scheme Regulation Act, 1996;
ii. The National Pension Scheme Act, 1996;
iii. The Public Service Pensions Act, Cap 260;
iv. The Local Authorities Superannuation Fund Act, Cap 284;
v. The Income Tax Act, Cap 323;
vi. The Companies Act;
vii. The Employment Act (Minimum Wages); and
viii. The Lands (Perpetual Succession) Act, Cap 186.

254. Prior to the enactment of the Pension Schemes Regulation Act of 1996, pension schemes were unregulated and were only required to register with Zambia Revenue Authority (ZRA) for tax exemption purposes. The Pension Scheme Regulation Act of 1996 provides for the administration and regulation of all pension schemes with the exception of the National Pension Scheme. The key features of this Act include:

i. The establishment of the Office of the Registrar of Pensions and Insurance, which registers all pension schemes **except the National Pension Scheme.** The National Pension Scheme Authority (NAPSA) which runs the National Pension Scheme reports to the Ministry of Labour and Social Services;
ii. The requirement to separate the assets of the employer and those of the scheme and that annual audits and actuarial valuations are done to assess the viability of the scheme assets;
iii. The provision for the portability of members' benefits from one scheme to another; and
iv. The requirements for submission of reports to both the regulator and the members.

255. While the Pension Scheme Regulation Act, 1996 explicitly bestows exemption on the National Pension Scheme, it does not do so in the case of the Local Authorities Superannuation Fund and the Public Service Pensions Fund, which are under the Ministry of Local Government and Housing and the office of the President respectively. The Income Tax Act, Cap 323 deals with tax exemptions for approved pension schemes, while the Pension Scheme Regulation Act, 1996 requires that pension schemes are established under trust. The Deeds Registry under Ministry of Lands handles the process of establishing trusts. Clearly this lack of harmony in the various pieces of legislation remains a major challenge to the development and regulation of this industry.

256. The Pension Scheme Regulation Act, 1996 provides for the regulation of fund managers. However, the Act does not define fund management. In addition, there is an apparent overlap with other authorities including the SEC, ZRA and to some extent the BoZ.

6.4.1.2 Industry Size

257. The total net assets of the occupational pension schemes were over K550.0 billion in 2002 while those of the National Pension Scheme were over ZMK500 billion. The total membership of the National Pension Scheme is currently over 360,000 while that of the supplementary pension schemes is over 203,430. The membership in supplementary pension schemes comprises 143,462 active members, 3,253 deferred and 56,715 pensioners.

Table 6.1: **Structure of the major Pension Schemes as at 30th September 2003**

Type and Institution	Members	Assets (K' Billion)
Statutory Pension Schemes		
NAPSA	330,000	500
LASF	22,907	31
Public Service Pensions Fund	130,012	70
Occupational Pension Schemes		
BoZ	692	46
Mukuba	14,798	64
African Life Financial Services	16,991	106
Professional Insurance Corporation Zambia	3,798	29
Madison Insurance Company Zambia	4,001	18
Zambia State Insurance Corporation	Over 3,000	98

Source: *Pensions and Insurance Authority*

6.4.1.3 Constraints and issues

258. The current pension system in Zambia suffers from a number of shortcomings. These include:

i. The unstable macroeconomic environment (low economic growth, high inflation and interest rates etc). The period following liberalisation has witnessed the closure or downsizing of several companies;

ii. The lack of harmony in the various pieces of legislation relating to the pension industry;

iii. Ambiguities in the Pension Scheme Regulation Act, 1996 with regard to prudential supervision and regulation;

iv. The lack of independence of the regulatory authority – the PIA. Although the PIA started operating in 1997, it is not a corporate body but rather a Department under the Ministry of Finance and National Planning. This arrangement has adversely affected the operations of the Authority;

v. The inadequate funding for the authority, which has resulted in the PIA failing to retain and train manpower to discharge its responsibilities;

vi. Despite the discontinuation of the Public Service Pensions Fund and the Local Superannuation Fund (LASF), the huge deficit and non-performing real estate assets continue to haunt the Pension Sector and represent a serious threat the financial sector stability. The deficit on the Public Service Pension Fund is estimated to be in the region of US $500 million, while that of the Local Authority Superannuation Fund is at US $30 million. The deficit is attributed to the Government's failure to remit contributions coupled with the poor economic growth and the consequent decline in formal employment;

vii. The absence of local actuaries. Currently Zambia is dependent on actuaries from South Africa and Zimbabwe for evaluations;

viii. The introduction of NAPSA witnessed a change in the mode of contribution to the National Pension scheme from a prescribed amount to a percentage of the member's salary. This change had a net effect of increasing both the sponsor's and the member's contributions. The rise in the contributions negatively affected the supplementary schemes to the extent where some have wound up;

ix. The absence of incentives has significantly affected the ability of pension funds to meet their liabilities as and when they fall due. The maximum amount allowed in computing an employee's PAYE is the lesser of K15,000 per month or 15%. This amount is completely swallowed by the deduction for the National Pension Scheme Authority statutory contributions. This implies that the contributions to occupational pension schemes are based on taxable amounts. Further the 15% withholding tax on pension funds is an additional tax to the members of pension schemes;

x. Lack of an assessment of the impact of HIV/AIDS on the pension schemes in Zambia;

xi. Closure or downsizing of several companies leading to closure of schemes;

xii. Lack of investment guidelines; and

xiii. Lack of knowledge concerning pensions by the public.

6.4.1.4 Progress made to date

i. Government has provided K24 billion in the 2004 budget to reduce debt of K263 billion owed to PSPF;

ii. Government has been current with the contributions to PSPF;

iii. Stakeholders Seminar on the PRSA Amendments was held in October 2003;

iv. Draft Amendments and Investment Guidelines were submitted to the Ministry of Finance and National Planning (MoFNP);

v. The private sector has made submissions on the Tax Reform;

vi. Refunds of employers' contributions are now permissible under the Income Tax Act; and

vii. Full complement of PIA Inspectorate has been attained.

6.5 RECOMMENDATIONS

i. Amend the Pension Scheme Regulation Act, 1996. In particular, the amended act should address issues of PIA's authority over all pension schemes and the supporting rules and regulations of matters relating to trusteeship, fund management, custodianship and general administration of pension schemes. In this regard, the PIA should be an independent body reporting to parliament rather than being a Department of the Ministry of Finance;

ii. Provide adequate funding to PIA, by 2004, to enable it fulfil its functions of regulation and supervision. PIA is currently a grant-aided organisation;
iii. Introduction of the office of the ombudsman to arbitrate disputes and decide appeals;
iv. Development of investment guidelines for the industries. Currently the investment guidelines are still in a proposal form. Submissions have been made to the Ministry of Finance;
v. Conduct educational campaigns on the importance of providing for retirement;
vi. Introduce laws and regulations that impose stricter Corporate Governance practices and structures in all institutions managing Pension and Insurance funds, for example as is the case in Banking, shareholding levels by any one person, family, group or related entities should be limited to some proportion, less than 50% in order to avoid possible abuse through undue influence and control in the governance management of the insurance or pension company;
vii. The national policy on pensions provision needs to be formulated and disseminated in the next few years to clear misunderstandings about the responsibilities and policy intents of different players;
viii. A study to ascertain the viability of the Personal Pension Plans should be initiated;
ix. The recent tax legislation relating to withdrawal of pension contributions should be reviewed and its impacts assessed;
x. National development should be subordinated to and be seen as a consequence of a well functioning contractual savings sector;
xi. The Investment Guidelines should take into account the country's limitations to avoid shackling the hands of investment managers;
xii. Training of local actuaries; and
xiii. NAPSA must be regulated by an independent authority.

6.5.1 Insurance

259. The insurance industry consists of the following insurance services providers; insurers, re-insurers, brokers, assessors, adjustors, and policy-holders. In 1970 the Government of Zambia formed the Zambia State Insurance Corporation (ZSIC) as a

monopoly insurer. This meant that the 26 foreign private insurers were to transfer their assets to ZSIC. This state of affairs remained until 1992 when the insurance market was liberalised.

260. Due to the liberalisation of the insurance industry, a number of local insurers have emerged thereby increasing competition. However, the market is still relatively small. Currently there is 1 re-insurer, 8 insurers, 36 insurance brokers, 3 loss adjusters, 8 assessors, 42 insurance agents and 3 claims agents. Liberalisation has brought in more players on the market, thereby increasing competition, but five out of eight insurance companies operating in Zambia are composite companies, writing both life and non-life business.

6.5.1.1 Regulatory Framework

261. The Insurance Act, 1997 is the principal piece of legislation governing the supervision and regulation of the insurance industry. Other pieces of legislation relating to insurance include the following:

i. The Companies Act;
ii. The Income Tax Act, Cap 323; and
iii. Banking and Financial Services Act.

262. The Insurance Act provides for licensing of insurers, brokers and other insurance services providers. It also provides for "fit and proper" test on the Chief Executive Officers of the insurance services providers.

263. As an insurance supervisor, the PIA's primary task is to maintain efficient, fair, safe and stable insurance market for the benefit and protection of policyholders. However, the Insurance Act in its current form is inadequate.

6.5.1.2 Size of the Insurance Industry

264. In 2002, gross premium received by insurers was K217 billion. Of this amount K181 billion was general insurance, while K36 billion was life assurance business. General insurance and life assurance re-insurance ceded amounted to K68 billion and K4.6 billion, respectively.

6.5.1.3 Constraints and issues

265. A number of factors contribute to the low level of supervision in both the pensions and insurance industries. Due to these factors, the PIA has not been very effective in its supervisory and regulatory role. The following factors could be attributed to this position:

i. The insurance Act is inadequate in many areas including licensing, separation of life and non-life business; investment outside the country, capital adequacy/minimum solvency based on risk and requirements on the publications regarding the overall financial condition and performance of the insurance industry;
ii. The insurance industry needs supplementary regulations and guidelines;
iii. Lack of independence and funding of the PIA;
iv. The current legislation is weak and ambiguous in a number of areas that have to do with prudential supervision and regulation. There are currently no regulations in place for both the Pension Scheme Regulation Act, 1996 and the Insurance Act, 1997;
v. Although the PIA started operating in 1997, it is not a corporate body but rather a department under the Ministry of Finance and National Planning. This arrangement has slowed down the operations of the Authority especially in the areas of decision-making, as authority has to be sought from the ministry before implementation. The absence of a board to monitor the activities in both the pensions and insurance industries has had a negative impact on the scheme members and policyholders;
vi. Inadequate funding has had a negative effect on the operations of the Authority to an extent that it has failed to maintain valuable human resources;
vii. Externalisation of insurance funds;
viii. Lack of capacity to handle mega risks; and
ix. Lack of insurance knowledge by the public .

6.5.1.4 Progress made to date

i. The Insurance Act amendments have been identified following a stakeholders meeting that was held in September 2003. Some of these include:
    a. Compulsory local shareholding in insurance companies;
    b. Exhaustion of local capacity prior to carrying out reinsurance;
    c. Foster investment of insurance funds in Zambia; and
    d. Revisit insolvency requirements and investment guidelines.

ii. Law requiring VAT to be paid on insurance brokerage has been amended; and
iii. PIA has enforced a training policy.

6.5.1.5 Recommendations

i. Restructure the existing relevant Acts namely, Pension Scheme Regulation Act, 1996 and the Insurance Act, 1997. The existing Acts have left out a number of pertinent areas in the regulation of pensions and insurance. These areas need to be included to ensure effective prudential supervision. As indicated under the pensions section regarding shareholding and control, the same should apply to the insurance sector with regard to introduction of laws and regulations that impose stricter corporate governance practices and structures in all institutions managing pension and insurance funds. For example, as is the case in Banking, shareholding levels by any one person, family, group or related entities should be limited to some proportion, say less than 50% in order to avoid possible abuse through undue influence and control in the governance and management of the insurance company. Insurance funds do not belong to the owners or directors of the insurance company, until the premiums become earned, and all provisions including solvency requirements are catered for, and a dividend declared;
ii. The Investment Act together with the Insurance/Pensions Acts should also be revised in such a way that all insurance companies being formed or already formed must have local ownership/equity partnership. This might help in the reduction of dividend repatriation/capital flight;
iii. Development of regulations to the Acts stated above. This will help in the implementation of the two Acts. For example, currently the PSRA has a provision for the pension schemes to be established as trusts but has not defined who should be a trustee. The lack of these regulations poses a lot of difficulties for both the PIA as regulator and the two industries;
iv. Establishment of the PIA as an independent body rather than being department of the MoFNP. In its current structure, PIA is not a legal entity and therefore cannot sue or be sued in its own right. The Authority would be more effective if it enjoyed some independence and reported directly to parliament;
v. Provide adequate funding to PIA to enable it fulfil its functions of regulation and supervision. PIA is currently a grant-aided organisation. Government funding ought to

be increased, and supplemented by some insurance levy charged to all insurance industry operators or on premiums or pension contributions;

vi. Adequate training and exposure also needs to be funded and made available to all PIA technical staff;

vii. Introduction of the office of the ombudsman to arbitrate disputes and decide appeals.

viii. Development of investment guidelines for the industries. Currently the investment guidelines are still in a proposal form. Submissions have been made to the Ministry of Finance;

ix. Conduct educational campaigns on the importance of providing for retirement;

x. The insurance regulations need to set new minimum capital requirements for establishing a broking company or agency as well as minimum qualifications for principal officers;

xi. Even though there are no foreign exchange restrictions in Zambia it is likely that such an extremely liberal environment is being abused. There should be put in place a mechanism to at least authenticate the nature of reinsurances being paid for and amounts being remitted as reinsurance premiums. Leakages of insurance funds/capital can occur by being hidden in such remittances;

xii. Although fronting is not illegal, the practice should be discouraged as much as possible. Huge amounts of money leave the market through fronting. The law/regulations should be devised to mitigate the practice.;

xiii. Creation of a Zambian reinsurance company would help in retaining some capital. Despite the liberalisation policy, consideration for some compulsory cession would need to be examined/debated;

xiv. Policy on the insurance of national assets should be devised;

xv. The dual roles of PIA should be reviewed either separately or in the context of a call for single regulator;

xvi. Health insurance should be developed and a regulatory framework devised; and

xvii. More thought should be given to how the development of the contractual savings sector benefits the average Zambians to avoid it being elitist.

6.5.1.6 Other issues

266. The FSDP should be in consonance with the objectives of the Poverty Reduction Strategy Paper (PRSP), the Transitional National Development Plan (TNDP) and the Millennium Development Goals.

7 THE FINANCIAL MARKET

7.1 INTRODUCTION

267. In the current global economic environment, well-functioning financial markets are an integral part of modern economies. The importance of financial markets in modern economies is underlined by the fact that well functioning and developed financial markets are considered to be a conduit for efficient and optimal allocation of financial resources necessary for the promotion of economic growth and development.

268. Prior to Zambia's economic reforms of the 1990's, the financial sector was strictly regulated. Credit, interest rates and exchange flows were controlled and the legal framework constrained the development of the banking industry. Credit controls entailed direct or selective allocation of funds to certain sectors of the economy, preferably the Government, agriculture and mining. In particular, parastatal organizations were given priority and received the bulk of the total credit allocated. Interest rates were administratively set with upper ceilings on lending rates and lower ceilings on saving rates while exchange controls were in the form of fixed exchange rate and restrictions on capital flows.

269. Under this paradigm of administrative controls, the financial system failed to flourish. The financial system remained under-developed, while lending patterns were inefficient. With inflation increasing faster than nominal interest rates, real interest rates drastically declined leading to low savings and investment and capital flight. Macro-economic performance also deteriorated as large negative real interest rates induced lower allocative efficiency and growth rates.

270. A growing awareness of these economic costs of financial repression led to financial liberalization as the dominant policy paradigm over the past decade. Therefore, financial reforms in Zambia since 1992 have entailed interest rate liberalisation, development of money and capital markets, removal of exchange rate controls and adoption of a market-determined exchange rate. Other measures have included improving and modernising the payments system and the regulatory framework.

271. The landmark of the beginning of liberalization in the financial sector was the abolishment of interest rate ceilings in October 1992. Both lending and savings interest rates have since been market determined. The decontrol of interest rates was the

cornerstone to the liberalisation of the financial system. The Government introduced the Treasury bill tender system in 1993. The primary aim of this system was to support the cash budget by financing maturing Treasury bills and bonds[7].

272. The liberalisation of interest rates was aimed at enhancing financial markets efficiency and spur savings mobilisation. Although lending rates have become positive in real terms, real savings rates are still negative, discouraging savings in the banking system. As a result individuals seek other alternative assets as store of value. The higher lending rates than savings rates have also given rise to huge interest rate spreads.

273. Commercial banks have maintained high lending interest rates partly due to the perceived risk associated with default and high volume of non-performing loans on their books.

7.1.1 CONSTRAINTS AND ISSUES

274. In the area of monetary policy management, it should be noted that although the economy seems to have attained relative macroeconomic stability, the rate of inflation is still high and the challenge to monetary authorities is the need to reduce current double-digit inflation rates to a single digit and to achieve a relatively stable and competitive exchange rate in order to enhance confidence in the financial markets.

275. Other challenges in the development of the financial markets in Zambia include:

i. *Limited financial instruments in the financial markets:* Government issued instruments of bonds and Treasury bills dominate the financial market in Zambia.

ii. *Inadequate knowledge and skills on the use and regulation of alternative financial instruments:* Innovative financial products such as negotiable certificates of deposits, bills of exchange and securitisation are hardly utilised in Zambia, with enterprises relying on more basic short-term financing instruments such as bank overdrafts. Other than absence of a legal framework that guides the trading of these instruments, this situation is also due to the lack of knowledge and skills regarding these instruments on the part of financial managers and board members of corporations. This has contributed to lack of innovation in the financial market.

[7] The cash budget, introduced in 1993 as a tightening fiscal policy measure, was aimed at complementing monetary policy in controlling inflation.

iii. *Underdeveloped secondary money and capital markets:* The secondary trading of financial instruments in the market is very low or non-existent in some cases. The development of the secondary market is crucial to the broadening and deepening of financial markets through increased liquidity and efficient price discovery.

iv. *An inefficient banking system:* The banking system is characterised by a number of inefficiencies as reflected in wide interest rate spreads and high bank charges (commissions) on bank services.

276. Common to the money, capital and foreign exchange market is the general absence of rules and guidelines that adequately guide market players.

7.2 MONEY MARKET

277. A necessary condition for the adoption of market-based instruments of monetary policy was the establishment of the money market. The money market is key in the providing short-term finance and investment options, determination of interest rates on long-term financial assets and the transmission of monetary policy. Currently, the Zambian money market comprises the interbank, discount and Treasury bill markets.

7.2.1 Interbank Money Market

278. The interbank money market is a market for short-term funds between banks and with some non-bank financial institutions such as pension funds in the quest to meet their daily liquidity demands. The Zambian interbank market is mainly concentrated in the overnight maturity for compliance on their settlement accounts at the BoZ.

279. In this market, transactions between the BoZ and commercial banks are backed by collateral through repurchase agreements, which was formalised in August 2001 when a Master Repurchase Agreement (MRA) was signed between BoZ and commercial banks[8]. This was meant to enhance the effectiveness of open market operations and the development of the inter-bank market.

280. The inter-bank market allows the participating banks to adjust their reserve position. The role of the BoZ under this facility is the maintenance of settlement accounts.

[8] The MRA is the legal document governing repurchase (repo) and reverse repurchase transactions under open market operations between the Bank of Zambia and commercial banks.

The major advantage of the facility is that no new reserves are created. Only a redistribution of existing reserves within the commercial banking system takes place.

7.2.2 Discount Market

281. The BoZ has a rediscount window, that is, a short-term refinancing facility where eligible investors may rediscount Treasury bills. This window represents the accommodation policy of the BoZ. This facility allows commercial banks to liquidate their Treasury bill holdings when they are faced with a temporary liquidity shortfall. Treasury bill rediscounts are used for the primary purpose of covering the settlement account shortfall incurred by the concerned commercial bank. Like the reserve and asset ratios, the rediscount facility attracts some penalty to deter commercial banks from regularly seeking recourse to this facility. This helps to enhance the use of more market-based instruments of managing their liquidity. Treasury bills are rediscounted at a relatively lower rate than what is obtaining in the market.

7.2.3 The Treasury Bill Market

282. The Minister of Finance in his 1992 budget speech announced that it was the intention of the Government to gradually move away from the system of financing government deficits by inflationary means. Hence, in January 1993, the Government through the BoZ introduced the tender system for selling of Treasury bills. This was also meant to reinforce the cash budget system adopted in the same year. Prior to this, BoZ sold Treasury bills on behalf of the Government at predetermined prices thereby enabling investors to purchase bills on any day and in any amounts or rediscount any amounts without restrictions. This made the management of liquidity injections in the economy by the BoZ difficult.

283. Currently, Treasury bills have terms to maturity of 28, 91, 182 and 273 days. Treasury bills are issued both on a competitive and non-competitive basis to the public every week.

7.2.4 Constraints and Issues

i. *While certain improvements have been registered in the primary market activity for government securities, secondary market activity remains extremely low.* Low secondary activity reduces the responsiveness of the money market to monetary policy**.** The tendency by commercial banks to hold securities to maturity has stifled secondary market activity. This may be partially due to absence of a sufficient number of financial institutions participating in the primary market for Government securities. In addition the high yield rates that have been prevailing have contributed. This is more evident with Government bonds because they are not rediscountable at BoZ and are not classified as core liquid assets.

ii. *The money market is dominated by commercial banks while other participants have the potential to play a bigger role.* Contributing to the non-participation of these financial intermediaries is the inadequacy of knowledge and skills in using money market instruments.

iii. *Poor cash management on the part of Government causes volatility in the interbank market.* A complicating factor in BoZ's liquidity management is the uncertainty in the Government's financial operations. The difficulty in reliably projecting Government's cash flows coupled with the ineffective response of the money market to OMO, hamper BoZ's influence on overall liquidity. These unanticipated upsurges in liquidity are the primary cause of volatility in the interbank money market.

iv. *Commercial banks hold huge balances in their settlement accounts*. This is caused by volatility in market liquidity, the 'one way' characteristic of the market and the high penalty rate at the discount window.

v. *Lack of the rules on securities clearing and settlement in the secondary market*. While there are clear primary market settlement rules and system for government securities, they are absent in the secondary market. The absence of such well articulated secondary market settlement rules and system brings about the issue of settlement risk.

vi. *Most market players do not have the necessary infrastructure that facilitates quick trading and settlement, particularly in the securities market.*

7.2.5 Progress Made to Date

i. In October 2003, the BoZ lowered the reserve requirement for commercial banks from 17.5% to 14.0%. The rationale for this action was to encourage the flow of credit to the productive sectors, particularly agriculture, through the release of loanable funds that would contribute to the lowering of the lending rates. This was also consistent with reducing reliance on direct instruments of monetary policy.

ii. Since the first quarter of 2004, Government borrowing through the issuance of Government securities has reduced, falling generally in line with the budgeted public sector borrowing requirements. This coupled with the reduction of the reserve requirement ratio has contributed to the decline of both the yield rates on Government securities and the commercial bank lending rates.

7.2.6 Recommendations

i. To develop secondary market activity, marker-makers in the securities market should be introduced. The development of the secondary market for Treasury bills will improve the responsiveness of the money market to monetary policy. The introduction of market makers should be followed with a well-articulated code of conduct in the securities market.

ii. The reliance on statutory reserve ratios in the BoZ's monetary framework should be minimised with indirect instruments playing a major role. Furthermore, with the development of the securities market, the BoZ should use repurchase agreements (repos) as the dominant instrument. The advantage of repos is that they are liquid and collateralised.

iii. Monetary policy accommodation policy should be reviewed with regard to liquidity financing facilities.

iv. To improve liquidity management, the Government should improve its cash management by adhering to the expenditure targets announced in the National Budget Speech. The BoZ should be informed of the Government cash outflows at least 24 hours before their effective transfer.

v. The BoZ in collaboration with all the stakeholders in the financial sector should address the problems in the secondary market through continuous interactions and development of rules and regulations for the secondary market. These should include the pricing principals, the master repurchase agreement for all market participants in line with the International Securities Market Association (ISMA) model and a code of conduct.

vi. Develop appropriate rules and guidelines to broaden and encourage active participation in the money markets.

vii. In addition to modernising the payment system, market players must acquire modern equipment that supports real-time transactions.

viii. In the harmonisation of the legal and regulatory framework, innovative concepts that support the development of the market should be supported.

7.3 CAPITAL MARKETS

284. The capital market is an integral part of the financial markets where long-term financial instruments are traded. The importance of a well functioning capital market cannot be overemphasized as it improves financial market efficiency and is the missing link in Zambia's long quest and search for economic development, sustainable economic growth and poverty reduction.

285. Prior to the liberalisation era, Zambia had no formal capital market. Firms relied mainly on retained earnings and loans from development financial institutions, such as DBZ, LIMA Bank and Co-operative Bank, for sourcing long-term finance. Hence, only firms in certain prioritised sectors and those with close ties (informal or formal) to these institutions were in a position to easily expand their activities. In the reform process, the development of capital markets was considered as key in enhancing the rate of capital formation and of importance in facilitating privatisation. There was no organised market for long term instruments hence most stocks were traded on over the counter basis with no formal rules and regulations. Therefore, in 1993, the Securities Act was passed to allow for the setting up of an institutional framework for the establishment of a formal capital market and SEC as a regulator.

286. Following the enactment of the Securities Act, the Government, with the assistance of the International Finance Corporation (IFC), established the Lusaka Stock Exchange (LuSE) in February 1994. This broadened the sources of finance for companies through the issuance of equity and/or debt instruments. Business houses can now source cheaper funds from investors by listing their shares on the LuSE instead of borrowing from commercial banks, often at high rates of interest.

287. The LuSE was organised as a single market with an upper tier, or Official List, and lower tier, or quoted sector. The upper tier comprises larger companies that have more than 300 shareholders and have complied with both SEC registration requirements and LuSE listing criteria. The lower tier is simply companies that have been registered with the SEC but have not sought admittance to the LuSE Official List.

7.3.1 The Legal Framework in the Capital Market

288. There are three main Acts that govern capital markets:

i. The BoZ Act gives the BoZ the mandate to act as the fiscal agent for the Government. With this authority, the central bank administers the primary issuance of government securities.
ii. The Securities Act provides for the regulation of the securities industry and the establishment of the regulatory body, the SEC.
iii. The Companies Act provides the legal framework for the formation and management of companies.

289. In addition to these, the Treasury Bills Act and the Local Loans (Registered Stock and Securities) Act empower the Government to borrow from the public through the issuance of Treasury bills, government bonds, stocks and debentures, while the Development Bond Act provides for the issuance of bonds for development purposes (Private-Public Partnership).

7.3.2 The Bond Market

290. The bond market is important for the capital market because it serves as a pricing benchmark and, in particular, promotes the development and growth of financial instruments and products. Currently the bond market is rudimentary and narrow. The main challenge is to develop broad and deep primary and secondary bond markets.

291. In the absence of a well functioning bond market, savers face a diminished array of financial assets. Savers will hold more substitute assets such as bank deposits and possibly less likely, equity and probably more non-financial assets such as property that reduce the supply of savings that can be mobilized for productive investments. This is true for Zambia. More people hold most of their savings in form of deposits and to a certain extent hold the funds in dollar accounts. Savers are forced to accept lower return in the absence of competitive financial instruments.

292. In Zambia, most firms rely more on the short term bank financing. These types of funds cannot finance long term investment projects that will in the medium to long term increase employment and economic growth.

293. Without serious competition from the bond market, the banking sector will be larger than it would otherwise be. Banks tend to have more deposits at lower cost because their customers have limited financial assets alternatives and, as such, banks have more corporate loans because the firms have few other sources of finance.

7.3.2.1 Government Bond Market

294. The development of the government bond market in any economy is very important in that it is the sure way the Government deficits can be covered in a less inflationary way. It is therefore imperative that the Zambian Government is encouraged to finance its budget deficits through borrowing from the market. The only way it would successfully fund itself through the market is by developing the market for long-term financial instruments.

295. Prior to 1995, government bonds were sold at a fixed interest rate and on an ad hoc tap basis. In 1998, the BoZ in collaboration with LuSE took steps to enhance and develop the secondary market in long term instruments by listing government bonds on the LuSE for secondary market trading. It was expected that the establishment of a formal central market in bonds would produce a number of benefits to the Zambian financial system and the economy such as the following:[9]

i. Enhanced liquidity in the secondary market;
ii. Price discovery and improved price formation as reflected in yields of bonds;
iii. Broader and much wider participation by both large (institutional) and small (individual) investors due to use of modern book entry system which eliminates the use of physical certificates;
iv. Better and improved transparency in all market dealings
v. Creation of financial markets depth; and
vi. Development and emergence of longer dated capital market instruments.

296. Currently, Government bonds are of three maturity categories of 12, 18 and 24 months, offered to the public on a competitive basis through tender and also through the non-competitive window for amounts less than K30 million.

[9] Bank of Zambia Circular Number SCH/CB/2/98

7.3.2.2 Corporate Bond Market

297. Currently, there are about four corporate bonds on the market of varying tenure ranging from 3-12 years. These include Farmers House for US $1million issued in 1999; Barclays Bank for K30 billion issued in 2003; Lunsemfwa Hydro Power US $7 million issued in 2003; and Arcades US $1.5 million issued in 2003. All these bonds are quoted or listed on the LuSE but are not traded actively. This situation reflects the nascence state of the corporate bond market.

7.3.2.3 Municipal and Utility bonds

298. There has been no municipal bond that has been issued.

7.3.2.4 Equity Market

299. As of December 2003, 11 companies had listed their shares on the LuSE while 4 companies had their shares quoted. These listed companies are Zambia Sugar Plc, Chilanga Cement Plc, Farmers House Plc, National Breweries Plc, British American Tobacco (BAT) Plc, BP Zambia Plc, Standard Chartered Zambia Limited, Trans Zambezi International (TZI), Taj Pamodzi Plc, Zambian Breweries Plc, and Zambia Consolidated Copper Mines PLc, Shoprite Plc and Zambeef Plc. Quoted companies include Bata Zambia Limited, Copperbelt Energy Corporation and Chibuluma Mines Plc.

7.3.3 Stockbrokers

300. There are three brokers licensed to deal on the LuSE, namely Cavmont Stock Brokers, Pangaea EMI Securities and Intermarket Securities. The number of brokers remains low reflecting limited trading volumes on the LuSE. This situation poses a challenge to capital markets development.

7.3.4 Institutional Investors

301. Institutional investors such as pension funds and insurance funds serve as the foundation for the capital market because of the large pool of funds they manage. To that

extent, an active base of institutional investments through domestic savings mobilisation and investment is critical for capital market development and growth.

302. There is a moderate pool of institutional investment in Zambia. In 2001 the pension sector alone accounted for some K600 billion, 4.3 percent of GDP, while the insurance sector (both life and non-life) represented a further K96.4 billion of investment.

7.3.5 Venture Capital Funds

303. Venture Capital Funds (VCFs) are essentially collective investment schemes whereby investors place their investment capital with other investors into a Fund with the aim of achieving greater impact and security than could be realised individually. VCFs seek to provide finance to enable businesses to start-up, expand or restructure through the use of equity and quasi-equity instruments such as preference shares convertible debentures, shareholders loans, etc that reflect the risk and reward relationship in investing in such businesses.

304. Zambia's venture capital (VC) industry is still at an infant stage of development, with two Venture Capital Funds. The first Venture Capital Fund to be established was the Zambia Venture Capital Fund (ZVCF), which was established in 1996 with a fund size of US $7.5 million, which was increased to US $12.5 million in 1997. ZVCF has made 12 Investments and divested out of some of them leaving 7 businesses in its books. The second Venture Capital Fund to be established was Cavmont/FMO in 1999 with a fund base of US $2.0 million. Cavmont/FMO has so far made 6 investments.

305. The size of investments range from US $150,000 to US $1,500,000 in various sectors that include horticulture, manufacturing, pharmaceuticals, hospitality/tourism, property/real estate, financial services, agro-processing, information technology and transportation.

7.3.6 Securities and Exchange Commission (SEC)

306. Apart from its supervisory role (of licensing, registration and authorisations for financial intermediaries, issuers of debt and equity instruments and collective investment schemes, respectively) and rule making, the SEC under the Securities Act has the responsibility to develop the capital market.

7.3.7 Constraints and Issues

307. The Zambian capital markets are characterized by the following features:

i. Very few financial instruments available and traded on the market
ii. A weak and low base of institutional investment capacity
iii. An inadequate development of Collective Investment Schemes which are an avenue for mobilization of small savings to participate in the capital market
iv. Lack of knowledge and information on stock market activity, although the first phase of a public awareness campaign was undertaken in 1995
v. Lack of skills for financial intermediaries
vi. Lack of a modern trading infrastructure
vii. Agreed market trading practices in line with international best practice
viii. Absence of the necessary information technology

308. There are two main weaknesses and constraints leading to the above identified characteristics:

i. *The institutional structure of the market is very weak*. This is because there is no concerted effort/policy/programs to stimulate the supply and demand of long dated financial instruments in the Zambian economy. The secondary market in bonds is undeveloped.
ii. There is *no clear Government policy to stimulate domestic investment through mobilisation of domestic resources and savings*. All successful developing and advanced economy countries have recognised the powerful force and impact of institutional investment/pension funds, insurance companies, and collective investment scheme. Institutional investment generates economic growth.

309. In addition to the above, the Zambian capital market also faces the following critical challenges.

i. *The macroeconomic environment:* Major impediments to the development of the capital market are the high inflation and interest rates that have characterised the macroeconomic environment. This leads investors to stay in the money market at the expense of the capital market.

ii. The poor performance of the privatisation exercise and the uncertainty that surrounded the mining sector in the latter part of the 1990's eroded confidence in the capital market. Because of this, the capital market has remained shallow with very low secondary activity.

iii. *The Capital Market in Zambia has remained small* both in absolute terms and relative to the size of the economy and is unlikely to contribute significantly to economic growth. Stock market capitalisation is currently below 10% of GDP, which is low in comparative terms. The number of companies listed has only grown modestly and the LuSE remains chronically under-utilised. Market capitalisation has consistently declined in dollar terms and the volume of secondary market share trading is negligible (especially once intra-company trading is taken out).

iv. *The regulatory model is financially unsustainable*. The SEC is under funded to the extent that it lacks adequate capacity to execute its statutory mandate.

v. *Regional integration:* Though some progress has been made in this area, there is need to fully integrate the LuSE with other regional stock markets so that Zambian companies can enjoy greater exposure to regional and worldwide investors. In September 1997 the LuSE adopted listing rules harmonized with those of the Johannesburg Stock Exchange (JSE) as a result of the SADC initiative towards regional integration. To date only one stock is dual listed while regional integration remains unexploited.

vi. *Bond maturities:* Currently the longest term to maturity of government bonds is two years. The absence of longer dated government bonds constrains the development of the capital market in that there is no pricing benchmark for similar instruments.

vii. *Credit rating:* The growth and development of the capital market requires the existence of credit rating agencies. Currently none exists and the key pre-requisite is attaining sovereign rating for Zambia.

viii. *Venture capital funding*. There is a shortage of long-term capital available to small and medium sized businesses and an opportunity exists for VCF's to fill this capital supply gap. The domestic market presently only has two active VCF, namely the Zambia Venture Capital Fund and Cavmont FMO with ZVCF earmarked for closure in 2005/6.

ix. *Capital supply gap*. There is a supply side problem in the provision of term capital in Zambia. Despite the presence of considerable investment demand in the market particularly from institutional investors, very few firms offer their shares to trade freely on the stock exchange.

x. Further, although a number of long term lines of credit have been established such as the Proparco & EIB Industrial Line of Credit administered through Stanbic, Barclays Bank and Standard Chartered Bank, and the World Bank funded Enterprise Development Fund, the stringent investment criteria applied on these facilities mean the majority of SMEs are unable to gain access to these funds.

xi. *Tax regime*. Attracting VCF's to set up in Zambia will require the tax regime to be reviewed and brought into line with those existing in countries where venture funds have flourished. This is likely to lead to a widening of the tax base through more companies entering the formal sector.

xii. The tax structure that is being sought to encourage growth of a local VCF industry includes the following:

a) *Income Tax:* There is a serious disincentive for investors to consider setting-up/investing in VCFs in Zambia due to a double taxation problem. This arises when Company Income Tax is paid in the investee company and again in the fund itself when it receives income (either in the form of dividends and/or capital gains) from the investee company. Investors could avoid this problem by investing directly. However, this would not occur because direct investment is deemed too risky. Investors prefer the collective nature of Venture Capital Funds with their added expertise and security.

b) *Property Transfer Tax (PTT)***:** An exemption from PTT would introduce best practice to Zambia so that transactional barriers and costs to investing in SMEs are reduced. This tax increases the cost of capital which in turn increases the required rates of return by VCFs, which in turn make the cost of capital to SME too expensive and potentially out of their reach.

c) *Value Added Tax on Management Fees:* For the VCFs to meet recurrent operating costs it is necessary to charge a fee for managing Funds of approximately 2.5% per annum to 3% per annum. An additional cost of irrecoverable VAT could seriously depress investor returns and adversely affect the fund's viability. To protect against this occurrence, a zero rating of the management fee received/due to Mancos and payable by VCFs is proposed.

d) *Withholding Taxes:* Whilst Withholding Tax (WHT) is not a direct tax (other than in the case of dividends where it is treated as a final tax) it does impact on cash flows of VCFs and again raises the cost of capital to investee companies. Most of VCF returns mainly come from capital gains at the end of an investment period, and thus between time of making an initial investment and realising it, there is often very little inward flows of income to VCFs. Paying WHT on the limited interest and dividend income earned in between investment circles by VCFs seriously constrains their cash flows to meet operating and management fees in the interim period between investing and realising an investment.

7.3.8 Recommendations

i. *Institutional investment guidelines*. There is need for the Minister of Finance and National Planning to promulgate the institutional investment guidelines via an SI and amendment to the Pensions Scheme Regulations Act to permit minimum investment thresholds.

ii. *Fiscal Incentives:* To stimulate both the demand and supply side, tax incentives are required, as they have been successfully used in many other countries. On the demand side, investments in long-term instruments transaction costs for those investing for a minimum of 3 years should be made tax deductible for individuals. On the supply side, corporation tax should be lowered to below 25%. Specific tax incentives for start up investments should be made for the private sector such as lower tax for a number of years.

iii. The Government should in the medium term obtain a sovereign rating to serve as a basis for the rating of private sector securities.

iv. Parliament should enact into law the proposed Central Securities Depository and the National Payment System draft bills already with the MoFNP.

v. With regard to the funding of SEC, there is a need to ensure that the resources allocated by Government are adequate to meet the objectives of regulation.

vi. The SEC and LuSE should carry out intensive awareness campaigns to improve the public's knowledge and confidence in capital market transactions.

vii. Clear government policies supporting economic empowerment of Zambians must be designed.

viii. Enhance regulations to reinforce SEC supervision of venture capital funds.

ix. Interest and dividends on capital market instruments should be exempted from tax in the hands of individuals.

x. Utility firms such as ZESCO and Lusaka Water and Sewerage should be encouraged to raise financing via issuance of utility bonds.

xi. The BoZ should initiate the process of encouraging banking groups to invest the difference between the financial corporate tax rate and the general corporate rate into private equity transactions via private Equity funds established for the empowerment of Zambians.

xii. Extend brokerages services to the post offices as access points for investing in securities

xiii. The Government in liaison with the BoZ should introduce longer-term Government bonds beyond the current two years. This will provide a benchmark return and yield curve for pricing long-term instruments. This will contribute to the development of the private sector debt market. This market will provide the private sector with long-term funds for long-term investment, thus reduce dependence on bank financing.

xiv. The law should be reviewed to allow some capital market instruments held by banks to qualify as required core liquid assets.

xv. Government should consider setting up a rating agency in order to rate all corporations that would like to issue financial instruments on to the market.

xvi. Encourage overseas funds to invest in Zambia Equity funds by signing double taxation agreements with counterpart countries.

xvii. Government should pass legislation that will require pension funds such as NAPSA, private pension funds, Public Services Pension Fund etc and insurance companies to have balanced portfolios for the money they collect from the public. The portfolio should balance among the various assets as prescribed by the authorities such as:

- Government securities
- Real Estate
- Listed securities
- Foreign investments
- Debt investments to private sector companies/local authorities
- Private equity (direct investment, private equity funds, for example, Zambia Venture Capital Fund)

xviii. Specialist Rescue Distressed Asset funds to be encouraged to create liquidity in banking system.

xix. Review of tax regime for VCF's to flourish. This is critical for attracting foreign investment.

xx. The long-term vision should be the creation of more Venture Capital Funds that are specialised by product type such as:

a) Empowerment Funds;
b) Infrastructure Funds;
c) Start-up Funds; and
d) Rescue Funds

xxi. Drafting a financial services charter to empower Zambians.

xxii. Government should ensure that all Telecommunications and Mining Corporations that have agreed to go public should immediately be listed on LuSE

7.4 FOREIGN EXCHANGE MARKET

310. Prior to 1992, the foreign exchange market was generally administratively controlled through the imposition of foreign exchange quarters and the implementation of a fixed foreign exchange rate regime. However, two attempts had been made to liberalise the foreign exchange market. The first attempt was made in 1985 when the auctioning system of determining the exchange rate was introduced while the second was made in 1989 with the introduction of the Open General License (OGL) and a dual exchange rate mechanism.

311. In 1994 the foreign exchange market was liberalised following the suspension of the Exchange Control Act of 1965.

312. Further steps were taken in developing the foreign exchange market by introducing a dealing window at the BoZ in 1993, and the introduction of broad-based interbank foreign exchange market in 2003. With establishment of the interbank system the BoZ dealing window was closed.

313. The rationale for introducing a broad-based interbank system was to address the shortcomings in the BoZ dealing window system, in particular, the multiple exchange rates exhibited in the various segments of the foreign exchange market. Additional shortcomings were the circumventing of the US$100, 000 per week limit and the equal treatment of allocating the available foreign exchange resources to all commercial banks regardless of capital base. Furthermore, despite commercial banks being allowed to trade freely in Zambia, a functioning inter-bank market in the traditional sense of the term with two-way pricing had never emerged.

314. There are several important advantages associated with the broad-based interbank foreign exchange system:

i. Firstly, the continuous presence of primary dealers has improved the liquidity of the foreign exchange market in the sense that participants are be able to get a price at anytime.
ii. Secondly, the two-way pricing system and the use of electronic posting allows information to flow more symmetrically among market-players, thereby encouraging competition and reducing market distortions such as adverse speculation.

7.4.1 Foreign Exchange Rate Policy

315. Consistent with the liberalisation policies adopted in 1992, market conditions determine the value of the Kwacha in relation to other currencies. In discharging the function of exchange rate management, the BoZ intervenes in the foreign exchange market by buying and selling foreign exchange. However, the BoZ only does so to specifically smooth exchange rate fluctuations. These actions are therefore aimed at achieving stability in the exchange rate in order to gain international competitiveness. The foreign exchange rate policy is therefore a supplementary instrument in effective monetary policy conduct in that the exchange rate sends signals reflecting underlying market fundamentals.

7.4.2 Constraints and Issues

316. *Absence of a developed forwards and swaps market.* The forward and swap foreign exchange markets play an important function through the process of hedging. Though there has been a notable rise in forward transactions between commercial banks and the business community since liberalisation, this market has never fully emerged.

317. *Dollarisation:* Due to the instability of the Kwacha against major currencies since the liberalisation of the foreign exchange market, organisations and business entities, in a bid to hedge against exchange rate risk, tend to quote and transact in foreign currencies for domestic goods and services. The practice of using foreign currencies for domestic transactions undermines the capacity of the BoZ to conduct monetary policy, as the foreign currencies are not within the jurisdiction of the central bank.

7.4.3 Progress Made to Date

318. Since the FSAP of 2002, the foreign exchange market has recorded some progress through the establishment of the broad-based interbank system. Basically this entailed the movement of the wholesale market from the BoZ dealing window to the commercial banks.

319. The broad-based interbank system has enhanced the transparency in allocation of foreign exchange and in the price discovery process. Since its establishment the exchange rate has registered considerable stability.

7.4.4 Recommendations

i. The BoZ, BAZ, ZAM and ZACCI should seek ways to establish a vibrant derivatives market. The banking community is capable and has the innovation to meet the business community's requirements.
ii. In relation to this, existing rules and guidelines governing all foreign exchange transactions should be reviewed and consolidated into a single document.

CHAPTER 7

Financial Markets

8 FSDP IMPLEMENTATION

8.1 INTRODUCTION

320. This chapter provides an immediate agenda for the implementation of the FSDP focusing on critical challenges that should be addressed in the next 5 years to push towards meeting the vision of the FSDP. A summary of the recommendations with measurable indicators, timeframes, monitoring mechanisms and implementing agencies is provided in Annex 2. The following activities are essential in achieving the objectives of this FSDP: (i) legal modernization (ii) strengthening of the regulatory capacity and (iii) sequencing of activities.

8.2 LEGAL INFRASTRUCTURE

321. It is imperative that the legal infrastructure relating to the financial sector is reviewed and harmonised. It is important that outdated legislation is overhauled and rationalised. In addition, the need to establish contemporary bankruptcy, antitrust, consumer protection, accounting, and auditing and corporate governance regimes cannot be over-emphasised. To this end, there is need for Government to expedite the enactment of several bills which are pending in 2004 parliamentary session.

8.3 STRENGTHENING REGULATORY CAPACITY

322. There is need to build capacity amongst industry regulators. The PIA and SEC especially require additional know-how and personnel to be effective and foster relative autonomy. Except for a few isolated cases, self-regulation generally is a void. It is recommended that within 1-5 years, each sub-sector in the financial sector should form a vibrant industry association that would ensure self-regulation in the respective industries alongside the independent regulatory authority.

8.4 SEQUENCING OF ACTIVITIES

323. The draft FSDP contains specific recommendations to address key financial sector issues. Underlying these recommendations is the need for Government and Bank of Zambia to continue implementing prudent fiscal and monetary policies to foster sustainable macroeconomic stability. Major recommendations include the following:

i. Setting up a formal Financial Sector Development Committee (FSDC) to oversee the implementation of the FSDP. The FSDC shall comprise key stakeholders who individually and collectively have an integrated view of issues and direction of the financial sector;

ii. Taking the final decision and adopting an action plan to address weaknesses of the state-owned non-bank financial institutions, notably the Development Bank of Zambia; the Zambia National Building Society (ZNBS); the National Savings and Credit Bank (NSCB); and the Zambia State Insurance Company (ZSIC);

iii. Repealing and/or harmonising the DBZ, NSCB, Building Society Acts to provide for full compliance with the BFSA;

iv. Enacting legislation for the payments system and establishment of a Central Securities Depository;

v. Bringing National Pensions and Savings Authority (NAPSA) under some independent supervisory authority and implementing the investment allocation guidelines for Contractual Savings Providers;

vi. Repealing or harmonising and strengthening all pieces of legislation relating to the financial sector;

vii. Strengthening the autonomy and enhancing the capacities of the regulatory authorities, namely, BoZ, PIA and SEC;

viii. Establishing a credit reference bureau and a Deposit Protection Scheme for banks and deposit-taking financial institutions to help enhance credit culture and instil confidence in the financial system;

ix. Developing a clear policy and an institutional framework for the provision of financial services in the peri-urban and rural areas;

x. Issuing Anti-Money Laundering guidelines to enhance the prevention and detection of money laundering; and

xi. Developing appropriate HIV/AIDS policies at places of work;

324. In order to successfully execute the FSDP, financial and human resources shall be required. It is expected that the key stakeholders including co-operating partners who have already shown keen interest will provide the much needed resources and technical assistance to facilitate smooth implementation. However the actual resource requirements shall be determined after the development of detailed work plans on the recommendations herein.